Costing, Pricing and forecasting techniques

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Introduction

Costing, pricing and budgeting are primary financing activities of any company. In this study, it is analyzed the costing, budgeting and pricing strategy of one brand of Hemas Manufacturing. “Velvet” is famous soap brand is Sri Lanka which is manufactured by Hemas Manufacturing. Hemas Manufacturing is one of subsidiary of Hemas Holdings PLC. Further in this study, appropriate costing technique will be proposed and discuss the negatives and positives of it. Further this study will be evaluate the finaical position of Hemas Holdings by conducting finaical appraisal.

The importance of costs in the pricing strategy of an organization

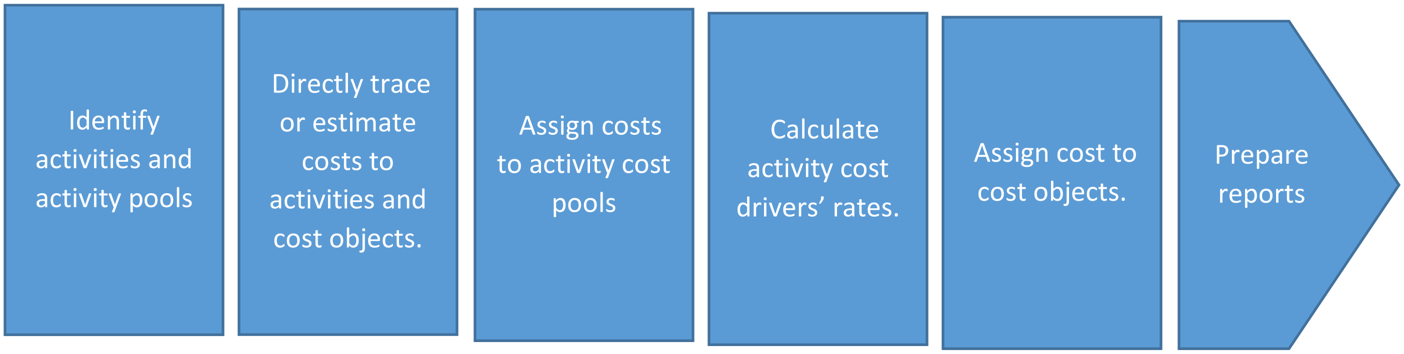
Pricing is one of the most important strategic issue since it is related to the product positioning. Price of a product is one major element of marketing mix. Hemas Manufacturing mainly use best cost strategy as their business strategy. Best cost strategy means provide premium products or services for affordable price (Diasz, 2017). In this case cost and price is highly important to continue their business strategy. Price need to be fit with the company marketing strategy (Cooper, 1989).

The various price strategies are available there such as cost plus pricing, competition based pricing, price skimming, penetration pricing, contribution margin based pricing and etc. A pricing strategy is a practical matter because company cannot succeed if company cannot earn enough to cover costs. Cost has been involved in different activities in different stages of value chain. Therefore management should have clear idea about the unit cost of the product to decide the price of the product according to marketing strategy of the company. Further customers need to feel the value for money therefore price need to be reasonable.

Activity Based Costing (ABC)

Activity based costing has been identified that the most appropriate costing method for manufacturing companies which has huge amount of overhead cost. Activity based costing refer as a method to the costing and monitoring of activities, that includes tracing resource consumption and costing final outputs. Resources are allocated to activities and activities to cost objects. The latter use cost drivers to attach activity costs to outputs (CGMA, 2013). Activity based costing is based on below steps.

Figure 01- The activity based costing process



ABC offers a more accurate method of product costing, leading to more accurate pricing decisions. It improves understanding of overheads and cost drivers; and help to identify costly and non-value adding activities, allowing management to reduce or eliminate them. ABC allows effective challenge of operating costs to find better ways of allocating and minimizing overheads. It also allows to add more value to the product and customer profitability analysis. It supports performance management techniques such as continuous improvement compare to traditional costing systems. (Turney, 1989).

Activities of Hemas Manufacturing can be identified as purchasing, receiving, vendor relations, disbursing, setting up the machine, running the machine, reorganizing and redesigning the product, taking customer orders, raw material inventory, finished good inventory, engineering charges, quality test, manufacturing and etc. The performance of these activities triggers the consumption of resources which are recorded as costs in the accounts.

Costing method can be made more successful by considering every level of employees' ideas. Further continuously monitoring the process will help to improve the costing method by identifying value added activities of the process. The main objective of using the activity-based costing method is to improve overall performance and profitability of an organization. The ABC method help to identify accurate overhead costs and cost drivers leading to more streamlined business processes. Once all direct and indirect costs are allocated to a product, management can get an idea of which business processes are efficient and which are inefficient. Then the management can streamline these processes by allocating more resources to profitable and value added activities and avoiding practices that are not profitable and wasteful.

Forecasting technique

Currently business environment change rapidly and current marketing or business strategy may not suitable for after years. Further future sales demand and customers' requirements need to be identified earlier to organize the future operation earlier. Consumer survey and regression analysis can be used to Hemas to forecast the future trends of the market.

According to regression analysis method, the value of related variables are established and forecasted based on one or severable values of independent variables. Simple regression analysis is used, if it is needed to identify a relationship between the revenue of the product and the expenditure on an advertising. On the other hand a multiple regression analysis is used when it is required to establish a connection between the product's revenue and the material cost, expenditure on advertising and promotion (Seckute and Pabedinskaite, 2003).

Further Hemas use consumer survey as a forecasting technique. A consumer survey normally provide most reliable data. The method of the random selection of potential consumers is applied most often, to reduce costs and labor power (Chambers, J. Mullick, S. and Smith, D. 1971)

Budgeting Process

Based on the forecasting technique, company can forecast the next year sales level approximately. When the company develop budget for next year, next year sales forecast is also considered. Budget has a role to play in control within an organization. So it is used to measure performance against the targets set in the budget. Mainly sales targets are based on the previous sales records and future sales forecasts. Normally company set realistic targets based on the previous sales records and also targets should be challengeable. Budgetary target is also play motivational role. The argument being that the budget gives employees a challenging target to try towards. However there is also an argument that if set at an inappropriate level it could be negatively affect to the employees' motivation (Porter and Stephenson, 2011).

Hemas Manufacturing is used "bottom up" approach to budget preparation. Therefore all the level of employees are participated to budget preparation. Each department prepare their department budget and send it to sector head for approval. When budget develop in department level everyone in the department involve to prepare the budget.

A budget variance is the difference between the budgeted expense or revenue, and the actual amount. When the actual revenue is higher than the budget or when the actual expense is less than the budget, the budget variance is called favorable. Some of overhead budget variance of Hemas Manufacturing of previous year has been calculated below.

Table 01 – Overhead budget variance

	Budgeted cost	Actual cost	Variance	Favorable/ unfavorable
Variable costs				
Indirect materials	2,386,145,764	1,764,983,094	621,162,670	Favorable
Indirect labor	78,342,879	75,863,529	2,479,350	Favorable
Utilities	1,087,568,257	1,032,903,437	54,664,820	Favorable
Fixed costs				
Supervisor salaries	33,823,091	35,456, 347	(1,633,256)	Unfavorable
Lease cost	1,245,000	1,245,000	-	

Number of actual production and budgeted production is maintain as same in previous years. Actual variable costs have been reduced compared to budgeted amount in 2016. This is mainly due to lean production approach which is introduced to reduce the production cost. However actual supervisor salaries has been increased compared to budgeted amount mainly due to improvement of the number of supervisors and the increase of the salary increments.

Even though there are many advantages of budgeting, few limitations can be also found. Budgets can lead to inflexible in decision making therefore budgets need to be changed when circumstances are changed. Budget can lead to result short term decision making to achieve the budgets rather than concern of long term decision making. Further management can be overloaded with setting and reviewing budgets and could miss to focus on the core business issues (Porter and Stephenson, 2011).

Currently Hemas Manufacturing conduct lean manufacturing approach to improve the operation efficiency. Even though main objective of the lean concept is not cost reduction, it help to reduce the cost by eliminating non value adding activities of the operation process (PWC, 2015)

And also Hemas can outsource some of none core activities to outside service providers which has special capability to do particular tasks. Further vendor selection need to review annually to identify the low cost service providers. However management need to highly consider to keep quality level when outsourcing tasks or vendor selection in order to reduce the cost.

Financial appraisal method

Financial appraisal support organizations to choose the most feasible and profitable from the number of available projects. Primary objective of any profit motive business is wealth maximization of shareholders. To maximize the shareholders' wealth, company need to conduct positive NPV generated projects. Net Present Value (NPV) is the most widely used financial appraisal method which is a standard method for evaluating financial feasibility of long term projects for investing. Using the NPV method a potential investment project should be undertaken if the present value of all cash inflows deduct the present value of all cash outflows is positive.

On the other hand, Interest rate of return (IRR) is a measure which is used in capital budgeting to forecast the profitability of investment. IRR is a discount rate that makes the NPV equal to zero. Theoretically, in any project which IRR is greater than cost of capital, it is considered as profitable one. Further when it comes to public company or if there is not a profit motive, cost benefit analysis is also suitable to make investment decision. Hemas recently acquired 75% Atlas pvt Ltd for Rs 5.7 million. Instead of positive NPV, investment should be fit for the company mission. Acquiring Atlas, Hemas can expand their portfolio further. And also investment improve the strength of the both companies due to synergic effort. Atlas will become the third largest business in the Hemas Hospitals PLC and operate independently as a subsidiary of Hemas Holdings PLC. However there can be cultural mismatch between two companies' employees. Employees who work for acquired company could be demotivated due to change of the management style.

Financial performance of the company

Ratio analysis is a broadly used financial evaluation mechanism which companies use to measure the financial performances. In here ratio analysis use to compare the Hemas Holdings performance with previous years. There are manly four kind of financial ratios such as profitability ratio, liquidity ratio, leverage ratio and leverage ratio.

Hemas Holdings revenue has been increased 14% in 2016. Operating profit margin in 2016 has been recorded as 11%. Operating profit margin has increased 1% in 2016 from 10% to 11%.

Current ratio shows that company's ability to pay back its liabilities. Current ratio calculate dividing current assets by current liabilities.

$$\text{Current ratio (2016)} = \frac{28,468,847,000}{15,993,943,000}$$

$$= 1.78$$

$$\text{Current ratio (2015)} = \frac{24,708,186,000}{13,437,\ 433,000}$$

$$= 1.83$$

Compare to last two financial year, current ratio has been maintain stable. This current ratio show healthy finaical position since current ratio is only increased marginally even though company borrowing has been increased 15%.

Further gearing ratio has been decreased by 13% from 18.5% to 16%. It shows that company has maintained healthy gearing level. Therefore company still have room for debt financing for future investment and financial institute are willing to provide finaical support to Hemas due to financial stability. However it is important to maintain balance financial position by maintaining right balance of debt and equity (Ogilvie, 2009).

Conclusion

This study has been discussed both operational and strategic aspects of the financing. When it comes to investment decision, company need to undertake projects that generate positive NPV. Further Hemas need to consider payback time of the investment. On the other hands, Hemas has more potion in funding. Instead of borrowing, debenture issue or right issue, company can also consider on using retaining reserve to invest on future projects. Overall Hemas has performed well in finaical aspects under challenging business environment.

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