

# 6.2

## COST CENTRE ANALYSIS AND CONTROLLING FINANCES

- Cost Centre Analysis
- Cost Centre Analysis Exercises

# COST CENTRE ANALYSIS

Any activity can be analysed by its costs and the 'output' it generates. Business may want to know the cost of administration compared to its level of bad debt. Or it might want to know the cost of running a production line compared to other production lines or ways of producing things.

Social benefit organisations that want to use financial systems for analysing performance may look at the cost of parts of its operation compared to the social benefit. For instance it might want to look at the total cost of running training courses (salary, rents, training materials, utilities and so on) compared to the number of people actually trained.

Cost centre analysis tries to attribute all costs involved in a particular activity to one 'location' or 'cost centre'. To calculate costs involved in a particular activity it is necessary to calculate the cost of:

## Materials

All materials used directly (including wasted materials) and materials used indirectly (for instance packaging).

## Labour

All labour costs directly involved (including National Insurance and pensions, for instance) and the proportionate cost of any supporting labour (for instance administrative staff).

## Sales And Marketing Costs

Regular, on-going costs of advertising and promotion of that activity's product or service.

## Overheads

Proportionate costs of regular expenses associated with that activity such as rent, rates, power, interest repayments, other charges.

## Additional Costs

Other costs solely attributable to the activity (for instance higher insurance costs for a new machine).

## Example

The Wood 'N' Tops management committee want to know the real cost of manufacturing toys. Materials used cost £2,000 per year. Production involves 5 trainees paid £500 expenses each per year. The single machine used is used for toy production 20% of the time and full depreciation is valued at £1,000 per year. Electricity costs £600 a year and toy production takes up half of a workshop costing £2,000 in rent, rates and repairs per year. The paid administration worker calculates that she spends 30% of her time on book-keeping, sales and marketing toys. She is paid £8,000 per year. The total income of the project is £25,000 per year and sales of toys contribute £5,000 to this. Its total costs are £24,500 per year.

### Cost Centre Analysis

Materials	£2,000
Labour (5 x £500)	£2,500
Depreciation (£1,000 x 20%)	£200
Electricity (£600 x 20%)	£120
Rent (£1,000 / 2)	£1,000
Administration (£8,000 x 30%)	£2,400
<b>Total</b>	<b>£8,220</b>

From these figures we can calculate the following:

Toy making is responsible for 34% of all costs ( $£8,220 / £24,500 \times 100$ )

Toy making generates only 20% of all income ( $£5,000 / £25,000 \times 100$ )

In a social benefit organisation like Wood 'N' Tops which is providing training to young people and cheap toys to local people who suffer many disadvantages this might not matter. But cost centre analysis gives a decision-maker the power to focus in on any part of a process that might be going wrong or where change might be beneficial or necessary.

Could work be organised more efficiently?

Does the equipment cost too much electricity? Could lower rates be negotiated?

Could prices be raised in a different market?

Another point is that community-based projects are increasingly being judged according to financial criteria. In the above example, Wood 'N' Tops could argue that the cost of toy-making may be £8,220 but that its cheap toys save local people money (higher prices in the high street shops and bus fares to the city centre, for instance), so that for the community as a whole the real cost is actually less than £8,200.

Measuring such 'savings' and 'costs' is increasingly feasible but using such calculations to convince funders and decision-makers remains difficult and little understood.

# COST CENTRE ANALYSIS EXERCISES

## Exercise 1 : Manufacturing Sector

The Wood 'N' Tops Furniture Project needs to generate income and is trying to work out if it should start a new production line making simple wooden toys as well its traditional activity repairing and making furniture. The joiner it employs has come up with the following figures:

- Materials to make toys would cost £2,000 per year
- Direct labour involves 5 trainees full-time, paid £500 expenses each year.
- The joiner would spend 40% of her time supervising; her salary is £8,000.
- A band saw would be required 20% of the time. Electricity bills associated with using it are £600 a year and full depreciation is £1,000 a year.
- Toy production takes up half of a workshop costing £2,000 in rent, rates and repairs per year.
- The paid administration worker calculates that he spends 30% of his time on book-keeping, sales and marketing toys. He is paid £8,000 per year.
- The total income of the project is £30,000 per year and sales of toys contribute £8,000 to this. Its total costs are £28,500 per year.

1 : What is the **total cost** of producing toys?

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2 : What are the costs of producing toys as a % of total costs?

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3 : What is the total income from producing toys?

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Suppose the project produces and sells 2,000 toys a year for £4 each and the joiner calculates a customer saves £1 per purchase over normal shop prices.

4 : Does toy making have a positive social benefit (in financial terms)?

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Answers can be found in the appendix on page 421

## Exercise 2 : Service Sector

The training and development officer for Wood 'N' Tops reports that she spends her time as follows:

- 50% training; 30% attending management meetings; 20% administration
- Her salary is £10,000 a year and training generates £100 for every 1% of her time spent delivering training.
- Administrative support costs £1,200, advertising £200, training materials and associated expenses cost £600 while a proportion of the overheads costs £500 a year.

1 : What is the **total cost** of delivering training?

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2 : How much extra time would the training officer have to spend training to cover the full costs of what she does?

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3 : Is there any way she can find the extra time?

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Answers can be found in the appendix on page 422