

# **CERTIFIED PUBLIC ACCOUNTANT**

## **ADVANCED LEVEL 1 EXAMINATIONS**

### **A2.2: STRATEGIC PERFORMANCE MANAGEMENT**

**FRIDAY: 5 DECEMBER 2014**

#### **INSTRUCTIONS:**

- 1. Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
- 2. This examination has one case study**
- 3. Show all your workings**

## CASE STUDY

### Capital Group Ltd

Crystal Group Ltd (CGL) is a holding company of Duon Ltd, Exta Ltd and Fulso Ltd. You have recently been appointed as the group management accountant of CGL.

As part of the shareholder agreement, CGL charges management fees to the subsidiaries. These costs are included in the administration costs for each company at a percentage of sales as follows: Duon Ltd: 7%, Exta Ltd: 9% and Fulso Ltd: 15%.

Part of these management fees is to cover training costs at the company academy located at the group head office and for handling tenders for services to be rendered to all operating companies.

At the start of each year, the group's Chief Finance Officer sets a target return on capital employed for each company. The target depends on the level of competitiveness of the industry in which the subsidiary operates. For the year ended 30 June 2014, the targets were: Duon Ltd: 6%, Exta Ltd: 3% and Fulso Ltd: 15%.

Each subsidiary company maintains its own accounting records and prepares an annual summary of its results. For the year ended 30 June 2014, the group chief finance officer presented the following summary of the results for all subsidiaries in the group as follows:

	<b>Duon Ltd</b>	<b>Exta Ltd</b>	<b>Fulso Ltd</b>
	<b>Frw “million”</b>	<b>Frw “million”</b>	<b>Frw “million”</b>
Sales	150	200	400
Variable production costs	50	70	230
Fixed production costs	60	50	80
Administration costs	30	25	40
Profits	10	55	50
Net assets and liabilities	400	550	415

The subsidiary companies are free to trade with each other without any interference from the group head office. The respective managers of the companies negotiate transfer prices between each other.

During the year and included in the above costs and revenues are the following transactions:

- Duon Ltd sold goods worth Frw 20 million to Exta Ltd. The price was agreed on a unit basis between the managers of the subsidiaries. The variable production costs of these items in Duon Ltd were Frw 18 million. Duon Ltd was operating under capacity and agreed to a transfer price that was above its own variable costs.
- Fulso Ltd sold goods worth Frw 15 million to Exta Ltd. The price was agreed on a unit basis between the managers. The variable production cost of these items was Frw 9 million. Fulso Ltd was also operating under capacity and negotiated a transfer price based on its total production costs.

The first subsidiary of Capital Group Ltd, Exta Ltd manufactures two products, Haks and Raks, in the same production facility.

Budgeted information for each product for the forthcoming quarter is as follows:

	<b>Haks</b>	<b>Raks</b>
Selling price (Frw “000”)	670	385
Cost per unit: (Frw “000”)		
Raw material @ Frw 11,000 per kg	220	55
Labour	180	100
Production overhead: (Frw “000”)		
• Variable	95	90
• Fixed	35	25
Selling and administration overhead: (Frw ‘000)		
• Variable	35	35
• Fixed	40	40
	<u>(605)</u>	<u>(345)</u>
Profit per unit	<u>65</u>	<u>40</u>

The following additional information regarding Exta Ltd is available:

1. Labour is to be regarded as a variable cost and is charged at Frw 20,000 per hour.
2. The unit fixed costs are based on the following budgeted sales estimates:
  - Haks 500 units
  - Raks 1,000 units

The sales estimate has been prepared by the sales manager based on the above selling prices.

Before finalizing the production plan for the forthcoming quarter, the production manager of Exta Ltd pointed out that he was concerned about meeting the budgeted sales volumes. Firstly, there was no stock of finished goods on hand at the beginning of the quarter and secondly, the supply of raw materials and labour for the quarter was limited. According to his forecasts, the maximum availability of these two resources for the quarter was as follows:

- Raw materials 13,000 kg
- Labour 10,000 hours

The second subsidiary of Capital Group Ltd, Fulso Ltd, manufactures one type of hydraulic jack. The labour force, who are all paid at the same rate, assemble and finish two bought-in components. Each jack uses two metal castings and one rubber seal. The jacks are very popular and Fulso Ltd sells all it can make.

Fulso Ltd budgets to make a profit of Frw 44 million each month.

The budget is as follows:

	Standard	Budget
	(1 jack)	(11,000 jacks)
	Frw	Frw
Rubber seals (1 at Frw 2,000)	2,000	22,000,000
Metal castings (2 at Frw 3,000)	6,000	66,000,000
Direct labour (10 minutes)	1,000	11,000,000
Fixed Overhead	7,000	77,000,000
	16,000	176,000,000
Sales revenue	20,000	220,000,000
<b>Profit</b>	<b>4,000</b>	<b>44,000,000</b>

The fixed overhead of Frw 7000 consists of production, marketing and administrative overheads. It is based on production and sales of 1,100 jacks.

In October 2014, the actual results were as follows:

Number of jacks made and sold	1,050
	Frw
Rubber castings (1,060 at Frw 1.95)	2,067
Metal castings (2,108 at Frw 3.25)	6,851
Direct labour (190 hours at Frw 5.9)	1,121
Fixed overhead incurred	7,600
	17,639
Sales revenue (1,050 at Frw 19)	19,950
Actual profit (Frw)	2,311



The third subsidiary of Capital Group Ltd, Duon Ltd, produces two products A and B and the following budget has been prepared:

	<b>A</b>	<b>B</b>	<b>Total</b>
Sales units	120,000	40,000	160,000
Sales (Frw)	600,000	400,000	1,000,000
Variable costs (Frw)	480,000	120,000	600,000
Contribution (Frw)	120,000	280,000	400,000
Total fixed costs (Frw )			300,000
Profit (Frw)			100,000

Duon Ltd has recently recruited Mr. Magezi Yohannes, a CPA graduate as its finance manager. CPA Magezi has been a top analyst in one of the leading financial services companies in Rwanda. In his first address to a retreat of senior managers of the company, he stated the following: “As my legacy to this company, I intend to put in place a budgetary control system that encourages goal congruence, does not contain budgetary slack, attempts to control operations by feedback and feedforward and tries to take advantage of the aspiration levels of all participants in the budgetary process”.

All the senior managers are excited by the new finance manager’s remarks. However, the plant manager, having an engineering background, seems not to be emotionally moved by the new finance manager.

**Required:**

- Discuss the shortcomings of the performance summaries presented by the group chief finance officer when measuring the performance of each subsidiary. **(5 Marks)**
- In respect of the whole group, discuss the potential problems of negotiated transfer prices and how these have impacted on the performance of each company for the year ended 30 June 2014. **(6 Marks)**
- Prepare an alternative statement that is more useful for measuring and reporting the performance of each company in the group. **(15 Marks)**
- Discuss how the use of “dual” transfer prices could affect performance measurement of the subsidiaries within the group. Illustrate your answer with suggested dual prices. **(4 Marks)**
- Using appropriate computations, establish if Exta Ltd has sufficient quantity of materials and labour to meet the sales requirements. **(10 Marks)**
- Determine the optimal production plan that will maximize profits for the forthcoming quarter in Exta Ltd. **(10 Marks)**
- In regard to Fulso Ltd:
  - Flex the budget to the actual level of the activity in October 2014. **(7 Marks)**
  - Analyze the variances in as much detail as the information provided permits. **(12 Marks)**
  - Prepare a profit reconciliation statement for October 2014. **(6 Marks)**
- Explain the concept “activity based management”. **(5 Marks)**
- In the case of Duon Ltd, compute the break-even point in units of sales and in monetary value. **(4 Marks)**
- Duon Ltd proposes to change the sales mix in units to a ratio of 1:1 for products A and B. Advise on whether this change is desirable. **(10 Marks)**
- Write a memo to the plant manager of Duon Ltd explaining the following terms as used by the CPA Yohannes Magezi, the finance manager:
  - Goal congruence.
  - Budgetary slack.
  - Feedback and feed forward.

**(6 Marks)**

**(Total 100 Marks)**

**End of question paper**