CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.2: STRATEGIC PERFORMANCE MANAGEMENT

DATE: THURSDAY, 26 AUGUST 2021

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 Minutes writing).
2. This examination has two sections: A & B.
3. Section **A** has one Compulsory Question while section **B** has three optional questions to choose any **two**.
4. In summary attempt **three** questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings where necessary.

SECTION A

QUESTION ONE:

Romano Company (RC) owns two branches as a way of diversifying its business in Rwanda: Romano Laptops (RL) and Romano Health Centre (RHC).

Romano Laptops (RL) makes laptop computers for use in dangerous environments. Their main customers are organizations in health sector and the military that require laptops that can survive rough environments whilst being transported to a site and can be made to their unique requirements.

The company started as a basic laptop manufacturer, but its competitors grew much larger and RL had to find a niche market where its small size would not hinder its ability to compete. It is now considered as one of the best quality producers in this sector.

RC as had the same finance director for many years who prefers to develop its business organically. However, due to a fall in profitability, a new Chief Executive officer (CEO) and a new Chief Financial Officer (CFO) have been appointed. The CEO wishes to review the financial control system in order to get information with which to tackle the profit issue.

The CEO wants to begin by thinking about pricing to ensure that selling expensive products and services at the wrong price is not compromising profit margins. The laptops are individually specified by the customers for each order and pricing has been on a production cost plus basis with a markup of 45%. The company uses an absorption costing system based on labour hours in order to calculate the production cost per unit.

The main control system used within the company is the annual budget. It is set forth before the start of the financial year and variances are monitored and acted upon by line managers. The CEO is concerned about the monthly board papers. The board papers contain a high-level summary of financial information, comparing performance against budget for revenue, costs, and profit.

The financial and other information for Romano Laptops are given below: ***Data for the year ending 31st March 2021***

Volume (units)		23,800
	Frw“000”	Frw “000”
Material		406,500
Labour		38,790
Packaging and transport		21,180
Subtotal		466,470
Overhead costs		
Customer service	77,350	
Purchasing and receiving	24,510	
Inventory management	14,670	
Administration of production	25,370	

Subtotal		141,900
Total		608,370
Labour time per unit		3 hours

Data collected for the year

Number of minutes on call to customers	899,600
Number of purchase orders raised	21,400
Number of components used in production	618,800

Order 2122

Units ordered	16
	Frw
Direct Material	273,280
Labour	26,080
Packaging and transport	14,240
Other activities relating to the order:	
Number of minutes on call to customers	1,104
Number of purchase orders raised	64
Number of components used in production	512
Administration of production (absorbed as a general overhead)	3 labour hours per unit.

RL has two divisions (component and assembly), plus the head office that provides design, administration, and marketing support. The manufacturing process involves:

i) The components division making the housing and electrical components for computers. This is an intricate process as it depends on the specific design of the laptops and serves as a significant advantage for the company.

ii) The assembly division assembles the various components into finished laptops ready for sale.

The finance director is currently overloaded with work due to changes in financial accounting policies that are considered at board level. As a result, she has not been able to look at certain management accounting aspects of the business and needs a review of the transfer policy between the components and assembly divisions.

The current transfer policy at RL is as follows:

a) Market prices for electrical components are used as these are generic components for which there is a competitive external market.
b) Prices for housing components based on total actual production costs to the component's division are used as there is no external market for these components since they are specially designed for RL's products.

Currently the components division produces only for the assembly division in order to meet overall demand without the use of external suppliers for housing and electrical components. If the components division were to sell its electrical components externally, then additional cost of Frw 2,690,000 would arise for additional transport, marketing, and bad debts. The finance director is considering changes to the transfer pricing policy in RL.

The transfer pricing policy for housing components would change to use variable cost to the components division and no change is proposed to the transfer price for electrical component. The financial information for the two divisions are provided as below:

Actual data for the two divisions for the year ended 31st March 2021

	Component Division	Assembly Division	Romano laptops
	Frw 000	Frw 000	Frw 000
Sales : Electrical	15,570		
Housing	82,040		
Subtotal	97,610	157,940	157,940
Cost of sales			
Electrical	8,040	15,570	
Housing	69,020	82,040	
Subtotal	77,060	97,610	77,060
Fixed production costs			
Electrical	3,700		
Housing	13,020		
subtotal	16,720	12,680	29,400
Allocated head office costs	4,610	20,460	25,070

The component division has had problems meeting budgets recently, with an adverse variance of Frw 5,750,000 in the last year. This variance arises in relation to the cost of sales for housing components production

On the other side, Romano Health Centre (RHC) specializes in the provision of sports/exercise and medical/dietary advice for clients. The service is provided on a residential basis based on the Ministry of Health Covid-19 protocols and the clients stay for whatever number of days suits their needs.

Budgeted estimates for the year ending 31st March 2022 are as follows:

i) The maximum capacity of the Centre is 50 clients per day for 350 days in the year
ii) Clients will be invoiced at a fee per day. The budgeted occupancy level will vary with the client fee level per day and is estimated at different percentages of maximum capacity as follows:

Client fee per day	Occupancy level	Occupancy as percentage of maximum capacity
Frw 36,000	High	90%
Frw 40,000	Most likely	75%
Frw 44,000	Low	60%

iii) Variable costs are also estimated at one of three levels per client day. The high, most likely, and low levels per client per day are Frw 19,000; Frw 17,000; and Frw 14,000 respectively.

The range of cost levels reflects only the possible effect of the purchase prices of goods and services. The probabilities of variable cost levels occurring at high, most likely, and low levels are estimated as 0.1, 0.6 and 0.3 respectively.

Due to the pandemic pay cut issues, the finance director is offering accountancy services as a side hustle to three different small businesses owned by Amina, Bote and Chadia in her neighborhood. The fee charged is Frw 150,000 per month which is the same for all clients, but the costs differ from each client and the costs that she incurred last month, and the causes of the cost have been analyzed as follows:

	Amina	Bote	Chadia	Monthly cost Frw
Hours spent on preparing accounts and providing advice	8	5	2	150,000
Number of requests for missing information	4	10	6	50,000
Number of payment reminders sent	2	8	10	20,000
Number of client meetings held	5	2	3	80,000

The finance director is concerned on whether she is making any profit from the extra work she is doing or whether to increase the number of clients.

Required:

a) **Evaluate the current system of costing against activity-based costing for Romano laptops in regard to the *order 2122* in the year ending 31st March 2021. Advise management on what course of action to take.** (14 Marks)

b) Assess the profitability of the finance director's clients and advice on the most profitable client. (6 Marks)

c) i) Advise Romano Health Centre on the client fee strategy to adopt using minimax regret criteria. (11 Marks)

ii) If RHC objective is to maximize the expected value of contribution, advise management on the best client fee strategy. (5 Marks)

d) i) Evaluate the current system of transfer pricing of RL. (8 Marks)

ii) Comment and advise the finance director on the impact of changing the suggested transfer pricing policy for the housing components . (6 Marks)

(Total: 50 Marks)

SECTION B

QUESTION TWO:

Cyiza Company is a clothing manufacturer in Kigali producing a range of dresses which it sells to Emeza Company which is the only customer. Emeza is a well-known retailer in Kigali. Emeza has recently been affected by Covid-19 pandemic as consumers have changed their purchasing preference to buying clothes online and as a result it is keen to reduce the inventory holding as a way of reducing its costs. Emeza has also discovered an excess of goods which it has to discount as consumer tastes appears to have changed more quickly than in the past.

Cyiza Company currently obtains its raw materials from four suppliers. Each of the suppliers operates differently in terms of the processes and procedures which they adopt in trading with Cyiza. Cyiza has been agreeable to this as the quality of raw materials supplied have been generally acceptable. More recently though, Cyiza noticed a reason to question the accuracy and quality of raw materials delivered from one of the suppliers. Another supplier now only dispatches material in full load quantities to optimize the use of delivery vehicles.

Cyiza's method of production is to produce individual dresses in long production runs which has helped in maximizing output. Goods which have not been produced to the required standard have traditionally been rejected at the end of the production process. The production manager has indicated that the current production method has been successful, as the company only has 5% of its goods returned from Emeza company due to poor quality.

Emeza company would like to move to a Just in Time (JIT) system of purchasing its goods from Cyiza company. The board of Cyiza are contemplating changing its purchasing and production approach as a way of preparing itself adopting the JIT principles. The CEO does not believe that the company will encounter any problems in adopting Emeza's requirements and has said that they have very good quality control practices and procedures in place and are confident that they are consistently supplying goods which are required at an acceptable price with high quality.

The CEO of Cyiza company has made available a list of costs which she believes addresses the relevant costs of quality:

	Frw "000"
Estimated costs for handling complaints	1,080
Material costs	16,000
Scrap (cannot be reworked)	464
Quality control supervisor's salary (employed full time)	280
Rework cost	576
Machine downtime	304
Product recalls and cost of goods returned	1,440
Labour cost of production	6,400
Quality audit	16
Foregone contribution of lost sales (estimated)*	680
Routine maintenance	64

The foregone contribution of lost sales is an estimate made by the CEO of potential sales lost to Emeza to problems related to production and delivery experiences by Cyiza Company. The CEO has recommended the cost of quality report to be incorporated as follows:

Cost of quality report headings
Cost of conformance:
Prevention costs
Appraisal costs
Costs of non-conformance:
Internal failure costs
External failure costs
Cyiza operates a responsibility based standard costing system which allocates variances to specific individuals. The individual managers are paid a bonus only when the net favorable variances are allocated to them. For the period of March 2021, the new production manager introduced a new system that uses local organic materials which were more expensive, but with better output. The company operates a JIT inventory system and holds virtually no inventory. The variance report for February and March 2021 is shown below: (Fav = Favorable and Adv = Adverse).

Manager Responsible	**Allocated variance**	**February Variance Frw 000**	**March Variance Frw 000**
Production Manager	Material price	250 Fav	21,000 Adv
	Material mix	0	6,000 Adv
	Material yield	200 Fav	4,000 Fav
Sales Manager	Sales price	400 Adv	70,000 Fav
	Sales contribution volume	350 Adv	30,000 Fav

The production manager is upset that he seems to have lost all hope of a bonus under the new system. The sales manager thinks its excellent and is pleased with the progress.

Required:

a) **Assess and explain the changes which Cyiza will have to make in the areas of purchasing and production in order to supply goods to Emeza on a JIT basis.**
(8 Marks)

b) **Evaluate and comment the potential quality cost changes in light of the proposed move to JIT by preparing Cyiza's cost of quality report as recommended by the CEO.** **(**10 Marks)

c) **Assess the performance of the production manager and the sales manager and indicate whether the current bonus scheme is fair to them.** (7 Marks)

(Total: 25 Marks)

QUESTION THREE:

DUHUZE Group (DG) has been created over the last four years by merging three medium-sized family businesses. These businesses are involved in making fruit drinks. Fina (F) makes and bottles healthy, fruit-based sparkling drinks. Stella (S) makes and bottles fruit-flavored non-sparkling drinks and Heza (H) buys fruits and squeezes them to make basic fruit juices. The three companies have been divisionalised within the group structure. A fourth division called Marketing (M) exists to market the products of the other divisions to various large-scale retail chains. Marketing has only been recently set up in order to help the business expand. All of the operations and sales of DG occur in Rwanda where there is a strong market for healthy non-alcoholic drinks.

The group has recruited a new Director of Finance (DF), who was asked by the board to perform a review of the efficiency and effectiveness of the Finance Department as her first task on taking office. The DF has identified the main area of improvement as the need to improve profit margins throughout the business and there is no strong evidence that new products or markets are required, but that, the promising area of improvement lies in better control practices. Currently the main method of central control that can be used to drive profit margin improvement is the budget system in each business. The budgeting method used is to take the previous year's figures and simply increment them by estimates of growth in the market that will occur over the next year. The growth estimates are obtained through a discussion between the financial managers at group level and the relevant division managers.

H and S divisions are in stable markets where the levels of demand and competition mean that sales growth is unlikely, unless by acquisition of another brand. The main engine for prospective profit growth in these divisions is through margin improvements. The managers at these divisions have been successful in previous years and generally keep the agreed budgets. As a result, they are usually comfortable with the changing of existing practices. F is growing faster and is being seen as the Star of the group. However, the group has been receiving complaints from customers about late deliveries and poor-quality control of F products. The F managers have explained that they are working hard within the budget and capital constraints imposed by the board and have expressed a desire to be less controlled. The marketing (M) department has only been recently set up and the intention is to run each marketing campaign as an individual project which could be charged to the division whose products are benefiting from the campaign. The managers of the manufacturing divisions are very doubtful of the value of division M, as each believes that they have existing strong reputation with their customers and that it does not require much additional spending on marketing. Similar to other divisions, the marketing division budgets are set by taking the previous year's actual spend and adding a percentage increase. For M, the increase corresponds to the previous year's growth in group turnover.

At present, the DF is harassed by the introduction of a new information system within the Finance Department which is straining the resources of the department. The board in their last meeting decided that the Finance Department should create and use a marketing budget effectively at DG. The DF has asked the management accountant at the group level, to do some preliminary work to help her decide whether and how to change the budget methods. The first task that she believes would be useful is to consider the use of rolling budgets. She thinks that the fast-growing F division may prove the easiest division to introduce the new ideas to.

F's incremental budget for the current year and actual results of Quarter 1 which has just been completed is given below. The cost of sales and distribution are variable and administrative costs are fixed.

	Q1 (Frw 000)	**Q2 (Frw 000)**	**Q3 (Frw 000)**	**Q4 (Frw 000)**	**Q1 Actual (Frw 000)**
Revenue	87,600	89,790	92,035	94,335	89,660
Cost of sales	48,180	49,385	50,620	51,885	49,315
Gross profit	39,420	40,405	41,415	42,450	40,345
Distribution cost	7,885	8,080	8,285	8,490	8,070
Administration cost	21,070	21,070	21,070	21,070	21,070
Operating profit	10,465	11,255	12,060	12,890	11,205

On the basis of Q1 results, sales volume growth of 3% per quarter is now expected. The Director of Finance has also heard about bottom-up budgeting and has been wondering how it could be useful in DG.

Required:

a) **Discuss the suitability of incremental budgeting in DG;** (8 Marks)

b) **Recalculate the budget for division F using rolling budgeting and assess the use of rolling budgeting in division F;** (11 Marks)

c) **Describe the factors that DG should have considered when setting up a new information system to avoid the challenges that the Finance Department is experiencing with the introduction of a new information system.** (6 Marks)

(Total : 25 Marks)

QUESTION FOUR:

Mezeneza Cakes bakes cakes, which are directly sold to the public. The new Production Manager (a celebrity chef) has argued that the business should use organic ingredients in its cakes production. Organic ingredients are more expensive but should produce a product with improved flavor and give health benefits to their consumers. It was hoped that this would stimulate demand and enable an immediate price increase for cakes.

The new organic cakes production approach was adopted at the start of march 2021, following the decision by the new Production Manager, though no change was made at that time to the standard cost card. The company operates a responsibility based standard costing system which allocates variances to specific individuals. The Production Manager is allocated variances for material price (total for all ingredients), material mix and material yield.

In March 2021, the following data applied:

Standard cost of a cake (no adjustment for the organic ingredient change)			Actual production details		
Ingredients	**Kg**	**Frw**	**Ingredients**	**Kg**	**Frw 000**
Flour	0.10	600 per Kg	Flour	5,700	3,705
Eggs	0.10	3,500 per Kg	Eggs	6,600	28,050
Butter	0.10	8,500 per Kg	Butter	6,600	59,400
Sugar	0.10	2,500 per Kg	Sugar	4,578	13,735
Normal Loss 10% of total input			Actual Loss	1,878	

The budgeted production and sales in March was 50,000 cakes while the actual production and sales for the month were 60,000 cakes. All cakes produced must weigh 0.36 Kg as this is what is advertised. The company operates a Just in Time (JIT) inventory system, and no inventory is maintained.

With the benefit of hindsight, the management of Mezeneza Cakes realized that a more realistic standard cost for current conditions would be Frw 2,000 per cake. The planned cost is unrealistically low.

Mezeneza cakes produces three types of cakes: Sweet, Flavored and Organic. The capacity of Mezeneza plant is restricted by process alpha. Process alpha is expected to be operational for eight (8) hours per day and can produce 1,200 units of Sweet per hour, 1,500 units of Flavored per hour, and 600 units of Organic per hour.

Selling prices and material costs for each product are as follows:

Product	Selling price per unit	Material cost per unit	Throughput contribution per unit
Sweet	1500	800	700
Flavored	1200	400	800
Organic	3000	1000	2000

Conversion costs are Frw 7,200,000 per day.

Required:

a) **Critically evaluate the performance of the Production Manager of Mezeneza Cakes for the month of March 2021 based on the original standard cost.** (9Marks)

b) **Assess the performance of the production manager based on planning and operational variances for the month of March 2021.** (5 Marks)

c) **i) Determine the profitability per day if daily output achieved is 6,000 units of Sweet, 4,500 units of Flavored and 1,200 units of organic.** (3 Marks)

ii) Calculate the Throughput Accounting Ratio for each product and comment on the results. (8Marks)

(Total :25 Marks)

End of question paper