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The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.



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Trainee Accountant
Workshop Series

July 2016

Current Issues in Strategic
Performance Management

Solutions to June 2015 Exam



Overview of workshop

- Structure of the P2 SPM examination paper.
- Current issues & recap on fundamentals.
- Recommendations for approaching the paper:
Getting the maximum marks.



Structure of the P2 SPM examination paper [1]

- “Loosely-stitched” case study.
 - Initial case study (approximately 500 words).
 - Followed by 5 questions, each containing additional information and approx 2 requirements.

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Structure of the P2 SPM examination paper [2]

- **Why** this type of case study?
 - For candidates, this format has the advantage of being slightly more structured than a wholly “open-ended” case study.
 - At this level (P2 SPM) wholly stand-alone questions would be too simplistic.

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Structure of the P2 SPM examination paper [3]

- Type of question:
 - Questions are mostly declarative, not directional.
 - A declarative question indicates the strategic or commercial problem facing the business, but does not tell the candidate how it should be solved.
 - A directional question would specify exactly what solution is required (e.g., “calculate the following list of variances”).

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Structure of the P2 SPM examination paper [4]

- **Why** the emphasis on declarative questions:
 - Syllabus: “select, integrate, and apply SPM techniques ... to business situations”.
 - Clients present a CPA with their business problems and ask for the CPA's professional assistance. Most of the CPA's expertise is in identifying how to address the business problems.
 - To address declarative questions, candidates need to apply strategic judgment & commercial acumen.

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Structure of the P2 SPM examination paper [5]

- **Open Book.**
- Advantages of the open book format:
 - Quick check (e.g., fact or formula).
 - “Comfort blanket”.

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Structure of the P2 SPM examination paper [6]

- Cautions about the open book format:
 - In the exam, weak candidates may spend too much time consulting their books (and therefore have too little time to write good answers).
 - Temptation for some candidates to transcribe or summarise material from open books instead of answering the question (e.g., which requires application of knowledge to the specific case).

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Structure of the P2 SPM examination paper [7]

- Cautions about open book (continued):
 - Examiners will give zero marks for material which was (or appears to have been) transcribed or summarised from open books.

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Current issues
and
Recap on Fundamentals

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Current issues & recap

- Fallacy
 - "Nothing ever changes in management accounting"!

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Current issues & recap

Fact

- Changes in MA / SPM are “less clearly signposted” than changes in FA / Tax (*not principally driven by new IFRS, Finance Acts, etc.*)
- Changes in MA / SPM are driven by changes in the business environment and in strategic priorities.

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Syllabus Area 1:
Advanced decision-making [1]

Pricing decisions:

- Optimisation model ($MC = MR$).
- Strategic considerations:
 - Multiple revenue streams for the same product (e.g., website paywall and advertising).
 - Revenue management (e.g., airlines try to “harvest” the maximum revenue from flights).
 - Bundling and minimum-term customer contracts (*inhibit customers’ freedom to “shop around”*).

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Syllabus Area 1:
Advanced decision-making [2]

Target & lifecycle costing:

Target costing

Price (“what the market will bear”)	Less: Required profit	Equals: Target Cost
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Lifecycle costing:

- Focus on the whole-lifetime costs and profitability of product.
- E.g., penetration pricing made possible by anticipated future “learning curve” cost savings.

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Syllabus Area 1:
Advanced decision-making [3]

- Applications of activity-based costing (ABC):
 - ABC **product** costing & management of the product portfolio.
 - Customer profitability analysis:
 - Which customers give us the least profit, and how can this be improved?
 - Segment profitability:
 - Which traceable costs are avoidable if a segment is discontinued?

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Syllabus Area 1:
Advanced decision-making [4]

- Theory of constraints (TOC):
 - Identify “bottlenecks” and optimise their use.
 - Non-bottleneck resources: Plan for “deliberate idle capacity”, to avoid WIP buildup.
 - Expenditure decisions, e.g.:
 - Reduced maintenance on non-bottleneck resources.
 - CX on expanding capacity of **bottleneck** resources.

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Syllabus Area 1:
Advanced decision-making [5]

- Management of risk:
 - Recommend “expected value” or “maximin” in a **particular business situation**.
 - E.g., quantify opportunity loss to shareholders if agents behave in a risk-averse manner.
- Decision-making with limiting factors (including linear programming formulation & interpretation).

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Syllabus Area 2:
Planning & control [1]

- Beware “solutions in search of a problem”.
- The issue is control.
- Critically appraise techniques [e.g., *budgets; variances*] to identify if they are the right solutions for the organisation’s control problems.

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Syllabus Area 2:
Planning & control [2]

- Technique: Budgeting
 - Incremental budgeting.
 - Zero-based budgeting.
 - Activity-based budgeting.
 - Rolling budgets.
 - Budget applied to engineered cost centres and discretionary cost centres.
 - “Beyond budgeting”.

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Syllabus Area 2:
Planning & control [3]

- Advanced variance analysis:
 - Technically more complex than “basic variances”.
 - Purpose = to provide variances which are more useful and actionable in terms of performance of particular business units

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Syllabus Area 2:
Planning & control [4]

- Advanced variance analysis: Examples:

Performance of ...	Variances
Production cost centre	Materials mix & yield.
Sales & marketing business unit	Sales mix & yield. Market share & market size.
ANY business unit	Distinction between planning variances ("budgetary error") and operational variances ("realistic performance assessment").

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Syllabus Area 2:
Planning & control [5]

- Typical exam Q on advanced variances:
 - Control problem is defined, e.g., need to:
 - Assess performance of a business unit with defined responsibilities and with a defined degree of delegated authority.
 - Assess recent impact of a major strategic decision, e.g., to cut selling price and go downmarket.
 - "Declarative question" solved by:

Identify APPLICABLE variances	Calculate those variances	Narrative interpretation
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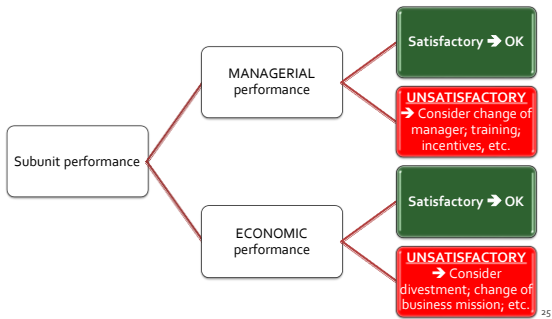


Syllabus Area 2:
Planning & control [6]

- Suitability of standard costing & variance analysis in a particular business situation??
 - Danger of reinforcing "functional silos".
 - E.g., cannot interpret raw materials mix & yield variances without including any market share effect in the analysis.

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Syllabus Area 3:
Performance evaluation [1]



Syllabus Area 3:
Performance evaluation [2]

- The distinction between economic and managerial performance lies in which costs (and revenues) the business unit manager can control.
- In principle, the same basic measures can be used for both economic and managerial performance evaluation.
 - Managerial performance evaluation requires difficult (and subjective) “calls” as to whether line items are controllable or uncontrollable.

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Syllabus Area 3:
Performance evaluation [3]

- “Success has many parents but failure is an orphan”:
 - Do not accept at face value any individual’s judgment as to which items were uncontrollable.
 - The same problem arises in distinguishing between planning & operational variances.
 - Possible approach:
 - Calculate performance measures on an economic basis.
 - “Park” the issue of uncontrollable items until the subsequent qualitative phase of performance evaluation

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Syllabus Area 3:
Performance evaluation [4]

- Two things which impact on the effectiveness of the performance measures used at the divisional level:
 - Which performance metric(s) are used, e.g., ROI, Residual Income, EVA™.
 - Whether the link between achievement of a target and payment of a bonus is “definitive” or “subjective”.

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Syllabus Area 3:
Performance evaluation [5]

- Transfer prices (TPs):
 - The need for a TP arises when one business unit buys a product or component from another business unit of the same company.
 - There is (and should be) “tension” between the two business units:

“Selling” business unit → wants to <u>maximise</u> TP	“Buying” business unit → wants to <u>minimise</u> TP
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Syllabus Area 3:
Performance evaluation [6]

- Typical exam Q in this area:
 - From the viewpoint of the company as a whole, what is the “optimal” number of units of transfer between the two division?
 - Assess various transfer prices (and/or transfer pricing models) to see if they would result in the autonomous business units deciding to transfer the “optimal number of units” as defined above.

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Syllabus Area 3:
Performance evaluation [7]

- Value-based management (VBM):
 - The economic success of a division is ultimately a matter of how much “shareholder value” has been created.
 - VBM involves achieving superior performance by focusing on various “drivers” (proxies) which will ultimately lead to the creation of shareholder value.

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Syllabus Area 3:
Performance evaluation [8]

- VBM [continued]:
 - Revenue and costs are “generic drivers” → have major impact on shareholder value but are not directly actionable.
 - “Level 1” drivers are more operational and specific, e.g., volume of website traffic is likely to be one factor which impacts on the revenue earned from a firm’s website (and hence on shareholder value).
- VBM → Shareholder value is ultimately created by acting on the lower-level operational drivers.

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Syllabus Area 4:
Performance evaluation [1]

- Possibly the least structured area of the whole syllabus.
- Nearly all questions on this topic require “thinking on one’s feet” in the exam.

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Syllabus Area 4:
Performance evaluation [2]

- For the organisation in the case study ...
 - Design a balanced scorecard.
 - Critically evaluate an existing incentive scheme.
 - Recommend an appropriate mix of financial and nonfinancial measures (for control purposes).
- How to answer:
 - Do design and tailor your answer to the specific case study.
 - Don't use "textbook examples" which are irrelevant to the case.

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Syllabus Area 4:
Performance evaluation [3]

- What competitive strategy would you recommend in this case?
- What information would you collect about competitors [and how] in this case. (*Questions will not be set which create an advantage for candidates working in a particular sector*).

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Syllabus Area 4:
Performance evaluation [4]

- The modern manufacturing environment and performance management, e.g.,
 - Determine the profit effects of implementing TQM & JIT.
 - Supply chain, e.g.:
 - An organisation's rules require all components to be sourced in-house (even where alternative external suppliers are available).
 - Implications for subunits' ability to negotiate TPs.
 - Implications for reported performance of each subunit.

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Syllabus Area 4:
Performance evaluation [5]

- Specification of strategies and goals.

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Syllabus Area 5:
Current developments in SPM [1]

- There are “current developments” in all areas of the syllabus, so this title is perhaps a misnomer!
- Note that Competency Level 2 is sufficient for this area (unlike other syllabus areas).
- Sometimes an exam question will combine Syllabus Area 5 with another area.

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Syllabus Area 5:
Current developments in SPM [2]

- Impact of developments in e-commerce and IT:
 - E.g., activity-based profitability of a firm’s sales through its website and sales through its retail store.

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Syllabus Area 5:
Current developments in SPM [3]

- Business process reengineering:
 - E.g., a supermarket accepts supplier deliveries to a central warehouse, and then makes its own deliveries to individual stores as needed.
 - BPR: Estimate cost savings (and changes to service levels) if suppliers were required to deliver directly to stores.

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Syllabus Area 5:
Current developments in SPM [4]

- Benchmarking:
 - Purpose = to roll out improvements to business practices, by learning from the "best in class" organisations.
 - Typical Q: Identify the usefulness and feasibility to the case study firm of a benchmarking exercise involving various "benchmarking partners".

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Syllabus Area 5:
Current developments in SPM [5]

- Corporate governance issues in SPM.
- Example:
 - An organisation purchased a building at a relatively high price and without normal CX procedures being followed.
 - The organisation is not using the building and it's not clear how the organisation plans to protect or recoup its investment.
 - Opportunity cost to the shareholders ??
 - Required changes to CX procedures ??

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Recommendations
for approaching the paper

- How to get the maximum marks.
- 5 Recommendations.

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Recommendation #1

- Don't just "calculate everything which can be calculated from the available data".
- Example: In answering a question about advanced variance analysis, first determine which variances it is appropriate to calculate:
 - E.g., "controllable performance of the sales & marketing department".

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Recommendation #1
Continued

- Consequences of presenting unnecessary calculations:
 - Waste of time.
 - More difficult to write a subsequent report, since both "relevant" and "irrelevant" variances have been calculated.

In any calculation question, always show workings.

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Recommendation #2

- Fully answer all parts of all questions.
- Example: A question may ask you to recommend what SPM technique should be implemented and to comprehensively justify your choice.
 - Marking scheme includes separate marks for the recommendation and for the justification.

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Recommendation #3

- Avoid the “half marks problem”.
- If asked to critically evaluate a proposal, it is important to address both sides of the argument.

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Recommendation #3
Continued

- Example: A firm proposes to greatly reduce the price-varying powers of its sales staff:

Arguments FOR proposal	Arguments AGAINST proposal
Reduces staff's temptation to make unprofitable sales.	Reduces staff's ability to dispose of hard-to-sell stock items.
Reduces customers' tendency to defer sales in hope of a bigger discount.	Reduces staff's ability to "invest in the customer relationship" by offering once-off special discounts.

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Recommendation #4

- In evaluating performance or making recommendations, don't be blinded by "conventional wisdoms", e.g.,

Sector	"Conventional wisdom"
Online retailing	It is more profitable to sell digital products than physical products.
Airlines	The "low cost model" is more profitable than any alternative.

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Recommendation #4
Continued

- "Conventional wisdoms" are often reinforced inadvertently by textbooks which use successful companies (e.g., Amazon, Ryanair) as illustrative examples.
- Regular reading of business and professional journal articles is the best way to keep to date with a wide variety of companies' experiences in implementing alternative business models.

In their respective sectors, Amazon and Ryanair have successful competitors which operate very different business models.

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Recommendation #5

- If you think the question can be answered by reproducing material from the "open books", then (1) you haven't understood it and (2) you are in danger of writing an irrelevant answer.
- Example:
 1. Case study describes a firm, its objectives, and its resources.
 2. Case study also describes a proposed new product and the firm's objectives (marketing and financial) for that product.
 3. Question asked of candidates: Recommend a pricing strategy for the new product, with detailed justification of your recommendation.

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Recommendation #5
Continued

- Example of ineffective answer to this question:
 - "Textbook list" of available pricing strategies.
 - Irrelevant material included [e.g., pricing strategies for products at "mature" stage of the product lifecycle].
 - Answer not focused on the specific circumstances of the particular company and product.
 - No clear recommendation and/or justifications.

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Recommendation #5
Further Continued

- Example of an effective answer:
 - Recommendation of a particular pricing strategy for the proposed new product.
 - Justification of that strategy:
 - Appropriateness of the strategy in the specific context of the case.
 - Including explanation as to why other new product pricing strategies are less appropriate in this case,

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Recommendation #5
Conclusion

- How this type of question is marked:
 - Separate marks for recommendation and justification.
 - The recommendation must be plausible and thoroughly argued, but there is "no one right answer".
 - The justification is marked on the quality and comprehensiveness of the argument, not on the "number of bullet points made".

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