



# Society of Certified Management Accountants of Sri Lanka

## Intermediate Stage March 2008 Examination

Examination Date : 8<sup>th</sup> March 2008

Number of Pages : 05

Examination Time: 9.30a.m.-12.30p.m.

Number of Questions: 06

### Instructions to candidates:

1. Time allowed is **three (3)** hours.
2. Answer **all** questions in **Section A**, **any two (2)** questions from **Section B** and **any one (1)** question from **Section C**
3. Answers should be entirely in the **English language**.

<u>Subject</u>	<u>Subject Code</u>
Advanced Management Accounting	(AMA)

### Section A

Answer **all** questions

**Question No:1 (40 Marks)**

#### Background

Fleet Ltd operates a chain of 'high street' retail outlets selling clothing and household items. In 2005 this company was heading for a financial loss and was deemed to have lost its strategic direction.

The business formula that had proved successful in the 1990s' and early 2000s' was no longer proving effective. A new chief executive was appointed to turn the company around. He put into effect a threefold strategy. Firstly he removed levels in the hierarchy, secondly he decentralized the organization and thirdly he focused on the core competencies or skills of the business.

These core skills were identified essentially as buying and selling. From this analysis, the philosophy of outsourcing was developed. The argument put forward was that the core activities have to be world class and that the organization must strive to achieve this. Further you need world class support, i.e. world class non-core activities. However, this is difficult, if not impossible to achieve in-house. This is because you need to use the people who are working in the forefront, or the core, of the industry. By definition, if your people are not in the forefront because it is a non-core activity.

The corporate philosophy and its outsourcing implication thus evolved in the organization, with anything that was not buying and selling becoming a potential candidate for outsourcing. For example distribution has been outsourced and has been reduced in size from 250 staff to three; quality control, packaging, and design activities have followed a similar pattern. Security and cleaning are currently in the process of being outsourced.

#### Organization Philosophy and Outsourcing IT

Outsourcing was thus the overall philosophy of the organization. However the organization would not do it just for the sake of outsourcing and it still needed to be shown that, if a particular activity was outsourced, improvements would result. In relation to IT the feeling of senior management was that IT was performing reasonably well in an operational sense but not really delivering its potential for the business. The IT departments are based miles away from the business, 'off-site', and are hard to manage. They had been fully centralized and the previous chief executive had told that they were going to be the hub and key to the smooth running of the company. Arrangements for the setting up of projects with the IT department were fairly informal and projects were tending to overrun budgets.

Fleet Ltd. decided to explore the possibility of outsourcing all of its IT needs. The process involved the selection from a shortlist of vendors which the organization felt to be capable of handling such a contract. The organization provided a brief to four vendors who were invited to provide an initial response. The selected vendor, Results Ltd., was the one that was felt to best understand the philosophy and objectives of the company, especially the area of development. Further, detailed negotiations were carried out with Results Ltd. Most of the details of the organizations performance requirements in IT had been defined in detail over the past three years, especially the key requirements of the stores and buying and merchandising.

The proposal from Results Ltd. is for a three year initial contract at a fixed price of Rs.250 million per year.

The initial response of the IT department to the possibility of outsourcing was negative. They expressed concern over the recent large investment the company had made in replacing all its computer systems. Rs.100 million had been spent only last year and they expected these systems would service the company for another three years.

Obviously there was deep concern over job security. Currently the IT department has ten staff earning, on average, Rs.30 million a year. The vendor had agreed to take on eight of these staff maintaining the terms and conditions they held with Fleet Ltd. Of the remaining two staff one, Mr. A, was eager to take early retirement and the other was to be retained within Fleet Ltd, at a salary of Rs.30 million a year, on contract, to assist management.

A manager to do outsourcing contracts would have to be appointed by Fleet Ltd. This would be a new appointment; the company did not currently have anyone with the required skills in-house, at an estimated salary of Rs.50 million, a year.

**Additional information provided by the finance director of Fleet Ltd.**

- If Mr. A retired two years early, Fleet Ltd. would have to pay an extra Rs.20 million lump sum into the pension scheme.
- The building, housing the IT department was on a three year lease and the organization was committed to an annual rental of Rs.10 million per year for the three year period. The building could be sublet if IT were outsourced generating Rs.4 million in the first year, Rs.8 million in the second and Rs.10 million in the final year of the lease.
- Current forecasts of consumables in the IT department are Rs.5 million, Rs.6 million and Rs.7 million over the next three years.
- The resale value of the IT equipment bought last year is Rs.30 million.
- Annual overheads for the IT department are Rs.27 million per year. 60% of the overhead varies with staff numbers, the remaining 40% is a share of central overhead charge.

**You have been appointed as a consultant to Fleet Ltd., you are required to prepare a report analyzing the outsourcing proposal, including both financial and non-financial effects, and give your recommendations.**

Your report should include:

- (a) An incremental costing analysis.
- (b) The effects on reported profits.
- (c) Discussion on other factors that need to be taken into account before a decision is made.
- (d) Recommendations with reasons.
- (e) An executive summary.

**(Total 40 Marks)**  
End of Section A

## Section B

Answer two questions only

### Question No:2 (20 Marks)

TJ Limited is in the industry sector, which is recovering from the recent recession. The directors of the company hope next year to be operating at 85% of capacity, although, currently the company is operating at only 65% of capacity. 65% of capacity represents output of 10,000 units of the single product which is produced and sold. One hundred direct workers are employed on production for 200,000 hours, in the current year.

The flexed budgets for the current year are:

Capacity level	55% (Rs'000)	65% (Rs'000)	75% (Rs'000)
Direct materials	846,200	1,000,000	1,153,800
Direct wages	1,480,850	1,750,000	2,019,150
Production overhead	596,170	650,000	703,830
Selling and distribution overhead	192,310	200,000	207,690
Administration overhead	120,000	120,000	120,000
Total costs	3,235,530	3,720,000	4,204,470

Profits in a year is budgeted to be  $16\frac{2}{3}\%$  of sales.

The following percentage increases in costs are expected for next year.

	Increase %
Direct materials	6
Direct wages	3
Variable production overhead	7
Variable selling and distribution overhead	7
Fixed production overhead	10
Fixed selling and distribution overhead	7.5
Administration overhead	10

**You are required to:**

- Prepare for the next year, a flexible budget statement on the assumption that the company operates at 85% capacity. Your statement should show both contribution and profit. **(12 Marks)**
- Discuss briefly three problems which may arise from the change in capacity level. **(4 Marks)**
- State who is likely to serve on a budget committee of TJ Limited and explain the purpose of such a committee. **(4 Marks)**

**(Total 20 Marks)**

**Question No:3 (20 Marks)**

AB Ltd manufactures a range of products. One of the products, Product M, requires the use of materials X and Y. Standard material costs for the manufacture of an item of product M in period 1 included, Material X: 9 kilos at Rs.120.00 per kilo.

Total purchases of material X in period 1, for use in all products, were 142,000 kilos, costing Rs.17,182,000. 16,270 kilos were used in the period in the manufacture of 1,790 units of product M.

In period 2 the standard price of material X increased by 6%, whilst the standard usage of the material in product M remained unchanged. 147,400 kilos of material X were purchased in period 2 at a favourable price variance of Rs.103,180. A favourable usage variance of 0.5% from standard occurred on material X in the manufacture of product M in the period 2.

**You are required to:**

- (a) Calculate:
- (i) the total price variance on purchases of material X in period 1. **(2 Marks)**
  - (ii) the material X usage variance arising from the manufacture of product M in period 1. **(2 Marks)**
  - (iii) the actual cost inflation of material X from period 1 to period 2, calculated as a percentage increase to one decimal place. **(4 Marks)**
  - (iv) the percentage change in actual usage of material X per unit of product M from period 1 to period 2, calculated to one decimal place. **(4 Marks)**
- (b) Describe, and contrast, the different types of standards that may be set for raw material usage and labour efficiency. **(8 Marks)**
- (Total 20 Marks)**

**Question No:4 (20 Marks)**

A company manufactures and sells a wide range of products. The products are manufactured in various locations and sold in a number of separate markets. The company's operations are organized into five divisions which may supply each other and sell on the open market.

The following financial information is available concerning the company for the year just ended:

	<b>(Rs'000)</b>
Sales	8,600
Production cost of sales	5,332
Gross profit	3,268
Other expenses	2,532
Net profit	736

An offer to purchase Division 5, which has been performing poorly, has been received by the company.

The gross profit percentage of sales, earned by Division 5 in the year, was half that was earned by the company as whole. Division 5 sales were 10% of total company sales. Of the production expenses incurred by Division 5, fixed costs were Rs.316,000. Other expenses, other than production expenses, incurred by the division totalled Rs.156,000, all of which can be regarded as fixed. These include Rs.38,000 apportionment of general company expenses which would not be affected by the decision concerning the possible sale of Division 5.

In the year ahead, if Division 5 is not sold, fixed costs of the division would be expected to increase by 5% and variable costs to remain at the same percentage of sales. Sales would be expected to increase by 10%.

If the division is sold, it is expected that some sales of other divisions would be lost. These would provide a contribution to profits of Rs.20,000 in the year ahead. Further, if the division is sold, the capital sum received could be invested to yield a return of Rs.75,000 in the year ahead.

**You are required to:**

- (a) Calculate whether it would be in the best interests of the company, based upon the expected situation in the year ahead, to sell Division 5. **(11 Marks)**
- (b) Discuss other factors that you feel should influence the decision. **(5 Marks)**
- (c) Calculate the percentage increase in Division 5 sales required in the year ahead, compared with the current year, for the financial viability of the two alternatives to be the same. You are to assume that all other factors in the above situation will remain as forecasted for the year ahead. **(4 Marks)**

**(Total 20 Marks)**

End of Section B

## **Section C**

**Answer one question only**

### **Question No:5 (20 Marks)**

**You are required to answer the following.**

- (a) What are the matters that need to be considered when setting a structure for an effective budgetary control system? **(10 Marks)**
- (b) Describe the pre-conditions which should exist if budget variance analysis is to be of value to an organization. **(10 Marks)**

**(Total 20 Marks)**

### **Question No:6 (20 Marks)**

The aims of zero-base budgeting have been described recently in the following terms:

‘Zero-base budgeting is a general management tool that can provide a systematic way to evaluate all operations and programmes; a means of establishing a working structure to recognize priorities and performance measures for current and future plans; in essence, a methodology for the continual redirection of resources into the highest priority programmes, and to explicitly identify tradeoffs among long-term growth, current operations, and profit needs.’

Explain how a system of zero-base budgeting works and assess its likely success in attaining the aims set out above. **(Total 20 Marks)**

End of Section C

End of Question Paper