

# Paper 2

## Performance management

### AIM

To develop a good understanding of knowledge required and techniques available to enable managers to measure and manage business performance within their organisation. Both financial and nonfinancial measures of performance are included in this paper.

### OBJECTIVES

On completion of this paper candidates should be able to:

- understand how performance measures should be linked to overall organisation strategy
- prepare budgets and use them to control and evaluate organisational performance
- identify and apply techniques that aid decision making
- identify and implement appropriate costing systems and business control systems
- identify and apply techniques to evaluate decisions in relation to: costing, pricing, product range, marketing strategy, purchasing and production strategies
- identify and apply non-financial performance measures, and understand the inter-relationships between different performance measures
- explain the behavioural and organisational consequences of using performance measurement and performance management techniques
- identify and apply techniques for evaluating the performance of divisions
- identify and explain issues that may cause performance not to meet expectations.
- demonstrate the ability to communicate in a range of formats.

### POSITION WITHIN THE SYLLABUS

Candidates are expected to have a good knowledge of basic accounting principles from subject area 1. Knowledge from subject areas 3 and 4 will be helpful but not essential.

### SYLLABUS CONTENT

The syllabus considers performance management from three broad and overlapping perspectives, namely: planning and decision making, measuring performance, and managing performance. There are also some general issues.

#### 1 General issues for performance management

- a Mission statements, objectives and targets
- b Responsibility centres
- c Information systems and costing systems to provide appropriate information
- d Overall organisation strategy and how performance measurement and management should enable strategy to be realised.

#### 2 Planning and decision making

- a Preparing budgets, including fixed and flexible budgets, cash budgets
- b Budgets in different contexts, including: manufacturing, sales, service industries
- c Alternative approaches to budgeting and planning
- d Decision making techniques required to determine plans that will maximise performance
- e Pricing policies and techniques for setting prices
- f Strategic planning and operational planning
- g The future of budgets and alternatives to budgeting
- h Costing data for decision making, and use of activity-based costing data
- i Transfer pricing policies and practices.

#### 3 Performance measurement

- a Financial measures of performance
- b Critical success factors and key performance indicators
- c Non-financial performance measures
- d Balanced scorecard
- e Benchmarking
- f Divisional performance measures.

#### 4 Performance management

- a Purchasing and production management
- b Activity-based management and business process re-engineering
- c Techniques for ensuring value-for-money, particularly re not-for-profit organisations
- d Techniques to ensure continuous improvement
- e Use of performance measurement techniques to manage performance
- f management of divisional performance, including transfer pricing issues
- g Behavioural and organisational consequences of performance measures, particularly budgeting and other accounting system data
- h Understanding of practical issues that may affect an organisation's ability to manage performance effectively
- i Incentive schemes linked to performance measures.

#### EXCLUDED TOPICS

No issues relating to performance management are specifically excluded.

#### KEY AREAS OF THE SYLLABUS

The key topics include:

- Decision making techniques to enable managers to maximise performance
- Budgeting and standard costing techniques to assess performance
- Costing systems and use of the data produced, including activity-based costing
- Techniques to aid performance evaluation of divisions
- Techniques to manage the performance of purchasing, production and sales functions
- Behavioural and organisational consequences of performance measurement
- Practical issues that affect a firm's ability to manage performance effectively
- Non-financial performance indicators.

#### RELEVANT TEXTS

The subject matter of this paper is drawn from management accounting and operations management. As a result there is no single text that adequately covers the whole syllabus.

Various titles are recommended below with some comments to direct students to a text that will meet their need. Note that in all these texts students will have to be selective as they cover more than the performance management syllabus.

A. Atkinson and R. Kaplan **Advanced Management Accounting** Prentice Hall

Covers many of the accounting topics and managerial techniques

D. Russell, A. Patel and G. Wilkinson-Riddle **Cost Accounting: an essential guide** Prentice Hall  
Brief treatment of budgeting, standard costs and ABC

Colin Drury **Management Accounting for Business Decisions** Thomson Learning

Deals well with the calculations and detailed management accounting issues

P. Attrill and E. McLaney **Management Accounting for Non-Specialists** Prentice Hall

Basic overview of the management accounting material

S. Brown, R. Lamming, J. Bessant, P. Jones **Strategic Operations Management** Butterworth-Heinemann

Covers the non-accounting aspects in a concise and readable manner

L. J. Krajewski and L. P. Ritzman **Operations Management – Strategy and Analysis** Addison-Wesley

Covers the non-accounting aspects

#### STUDY GUIDE

#### GENERAL ISSUES

##### 1 General issues for performance management

Syllabus reference 1a, 1b

- Explain the purposes of and interrelationships between mission statements, strategy, corporate objectives and targets
- Discuss the importance of relating performance measurement and performance management to the overall mission, strategy and objectives of the organisation
- Describe the nature of responsibility centres, such as investment centres profit centres, cost centres, revenue centres.

- Identify and discuss different organisational structures.
- Explain the benefits and drawbacks of decentralisation and how such drawbacks can be overcome.

## 2 Information systems and strategy

Syllabus reference 1c, 1d

- Describe and evaluate different types of information systems that provide the information required for performance management
- Explain the features of resource planning systems and management information systems (MIS)
- Describe the role of costing systems, and evaluate their strengths and weaknesses
- Describe the links between overall corporate strategy and performance management within an organisation.

## PLANNING AND DECISION MAKING

### 3 Preparing budgets

Syllabus reference 2a, 2b

- Prepare budgets for a range of purposes including sales, production and purchases, expenses and the master budget
- Explain the differences between fixed and flexible budgets
- Prepare a cash budget
- Prepare budgets for different types of organisations, such as manufacturing, service companies, not-for-profit organisations
- Interpret the information included in the budgets
- Critically appraise the assumptions used in preparing budgets.

### 4 Beyond basic budgeting

Syllabus reference 2c, 2f, 2g

- Distinguish between strategic planning and operational planning
- Explain and evaluate the appropriateness of different budgeting approaches, such as zero-based budgets and activity-based budgets
- Evaluate the critique of budgeting, 'beyond budgeting'
- Evaluate alternatives to budgeting.

### 5 Decision making techniques I

Syllabus reference 2d(i)

- Distinguish fixed and variable costs, and combinations of these two costs
- Explain the assumption of linearity and the limitations of this assumption
- Demonstrate understanding of the cost-volume-profit (CVP) model
- Prepare breakeven charts, profit-volume charts and margin-of-safety calculations, and interpret the information prepared
- Comment on the limitations of CVP analysis and other factors that may need to be considered with CVP information.

### 6 Decision making techniques II

Syllabus reference 2d(ii), d(iv)

- Define and distinguish between relevant costs, sunk costs and opportunity costs.
- Explain the concept and use of incremental costs
- Use an incremental cost approach to decision making, particularly for make-buy decisions and additional/special orders
- Explain and illustrate the impact of limiting factors/scarce resources in decision making
- Prepare simple calculations to determine the optimal mix of products where there are limiting factors (simplex calculations will not be required).

### 7 Decision making techniques III

Syllabus reference 2d(iv), f, h

- Demonstrate simple techniques for decision making under uncertainty, such as conservatism, sensitivity analysis, 'maximin-minimax'
- Demonstrate the use of probability estimates and expected values in decision making under uncertainty
- Comment on the strengths and weaknesses of the techniques mentioned above.

### 8 Pricing policies

Syllabus reference 2e

- Identify and discuss market conditions that will affect the choice of pricing policies, including price elasticity

- Discuss different pricing policies and strategies with which they would be appropriate, for example: skimming and penetration policies
- Calculate prices using various techniques, such as: full cost-plus, variable cost-plus, variable cost, and explain when different techniques might be appropriate
- Explain the operation of target costing, apply to examples
- Discuss the implications of different pricing techniques, for example marginal cost for certain short-run pricing decisions
- Evaluate the implications of activity based costs for pricing

### 9 Transfer pricing

Syllabus reference 2i

- Identify the circumstances where transfer pricing will be required, and the issues that will arise, particularly in relation to the nature of divisionalisation
- Explain the 'general rule' for transfer pricing and discuss its application
- Discuss the different techniques for setting transfer prices and evaluate their applicability in different situations and divisionalised structures, including: market-based prices, marginal cost transfers, cost-plus prices and negotiated prices
- Discuss the impact of transfer prices on divisional performance assessment.

### 10 Activity-based costing I

Syllabus reference 2h

- Discuss the ways in which costing data is used in decision making
- Explain the concept of 'different costs for different purposes' and discuss the issues that arise from this
- Outline the background to the development of activity based costing
- Calculate simple activity-based costs and compare with traditional volume-based costing methods.

### 11 Activity-based costing II

Syllabus reference 2h

- Explain the different uses to which activity-based cost data can be applied
- Demonstrate the use of activity-based cost data for

make/buy and outsourcing decisions

- Demonstrate the use of activity-based cost data for product continuance decisions
- Demonstrate the use of activity-based cost data for customer profitability analysis and decisions
- Discuss other relevant factors that need to be considered in conjunction with cost data
- Discuss the problems of implementing and using activity-based techniques, and discuss how these problems might be minimised.

## PERFORMANCE MEASUREMENT

### 12 Budgeting and standard costing

Syllabus reference 3a(i), 3a(ii)

- Demonstrate the use of budgets to measure performance
- Evaluate actual results compared to budget and calculate budget variances
- Explain process of setting standard costs, and use of standard costs to set targets
- Calculate standard cost variances and prepare operating statements
- Evaluate performance using standard cost variances
- Identify possible causes of variances
- Recommend action using standard cost variance analysis
- Discuss the relevance of the original budget, and its assumptions, when interpreting standard cost variances.

### 13 Measures of shareholder value

Syllabus reference 3a(iii)

- Explain the importance of the shareholder value concept, and discuss its limitations, for example in comparison with stakeholder approaches
- Explain and apply the common methods for measuring shareholder value, such as: profit, return on assets, return on sales, economic value added (EVA®)
- Discuss problems of implementing shareholder value measures and approaches to minimise these problems.

### 14 Critical success factors and nonfinancial performance indicators (NFPIs)

Syllabus reference 3b, 3c

- Discuss the implications of the growing emphasis on NFPIs, and the benefits their use might bring to an

organisation

- Discuss the interaction of NFPIs and financial measures of performance
- Identify and comment on NFPIs in relation to: employee performance, quality, customers, supply chain etc.
- Explain the concept of critical success factors (CSFs)
- Discuss the relation between critical success factors and strategic targets
- Discuss the problems that may arise in implementing and using NFPIs and CSFs for measuring performance.

### 15 Balanced scorecard and benchmarking

Syllabus reference 3c, 3d

- Explain the development of the balanced scorecard as proposed by Kaplan and Norton
- Explain the main features of the balanced scorecard and the interaction between the different perspectives
- Discuss the implementation of a balanced scorecard, the selection of measures to be used, and who should own the implementation process
- Evaluate the benefits and problems that might arise from using a balanced scorecard
- Explain the concept and potential benefits of benchmarking performance measures
- Discuss the problems of implementing and using benchmarking techniques and action to overcome such problems
- Discuss the relationship between balanced scorecard and benchmarking.

### 16 Divisional performance measures I

Syllabus reference 3f

- Discuss the general issues in relation to assessing the performance of divisions, especially the importance of the nature of divisions
- Calculate the basic divisional performance measures: accounting profit, return on investment, residual income, controllable profit, and cash flows
- Discuss the strengths and weaknesses of the above measures and the conditions where each measure would be appropriate.

### 17 Divisional performance measures II

Syllabus reference 3f, 4f

- Explain the development of economic value added (EVA®)
- Discuss the strengths and weaknesses of EVA®
- Discuss the problems of implementing EVA® and actions to overcome such problems
- Discuss the relationship between financial measures of divisional performance and non-financial measures
- Discuss the issues that arise when divisions are assessed, including problems that arise from using a range of different performance measures
- Comment on the issues that arise in relation to assessing divisional performance and the performance of the divisional management and make suggestions for improvements
- Discuss the inter-relationship between divisional performance measures and transfer pricing
- Discuss the action needed by management to ensure divisions operate effectively in line with the whole organisation's objectives.

## PERFORMANCE MANAGEMENT

### 18 Performance in operational and production management

Syllabus reference 4a

- Outline the key elements of operations management, including: procurement, logistics, production management, and quality management
- Distinguish between functional operational structures, matrix structures and process-based structures
- Discuss production issues, such as: 'lean manufacturing', 'focus factories', 'flow-line production', 'cell production', and discuss the implications for performance management
- Explain the problems that may arise in the transition between different production systems
- Explain the basic features of MRP and MRP II systems
- Explain the basic features of optimised production technology (OPT) and theory of constraints, and contrast with MRP systems
- Discuss the information that is available from production planning systems and its use in managing performance.

### **19 Supply chain management and e-procurement**

Syllabus reference 4a(i), 4a(ii)

- Explain the basic features of the supply chain; including: environmental factors, technology, suppliers, production (of goods or services), customers, and logistics
- Discuss strategies and measures that have been used to improve performance in the supply chain.
- Discuss measures that can be used to control and improve supply chain performance, and comment on issues that can arise
- Explain the changes in procurement procedures that have taken place using electronic data transfer and the internet
- Discuss measures that can be used to control and improve e-procurement performance.

### **20 Out-sourcing, joint ventures and partnerships**

Syllabus reference 4a(v)

- Discuss the changes in the nature of the supplier relationship in recent years
- Explain the benefits and weaknesses of out-sourcing
- Discuss measures that can be used to determine whether out-sourcing would improve performance and measures that could be used to control this process once implemented
- Discuss the benefits and weaknesses of joint-ventures and partnerships between supplier and customer
- Discuss measures that can be used to determine whether a joint-venture or partnership would improve performance and measures that could be used to ensure continued improvement through such relationships.

### **21 Just-in-time**

Syllabus reference 4a(iii)

- Explain the just-in-time production and just-in-time purchasing philosophy, including the kanban system
- Discuss operational issues that arise as a result of implementing just-in-time
- Discuss financial consequences, in the short-term and medium-term, of implementing just-in-time procedures
- Discuss measures that can be used to control and improve production and procurement performance if

just-in time procedures are implemented.

### **22 Target costing and kaizen costing**

Syllabus reference 4a(iv), 4d

- Explain the basic features of target costing and contrast these with traditional cost-plus costing procedures
- Discuss the cost reduction objectives of target costing
- Explain techniques that can be used to ensure continuous improvement in performance
- Discuss the features of kaizen costing and how these may help to manage performance.

### **23 Activity-based management**

Syllabus reference 4b

- Explain the main features of activity-based management (ABM)
- Contrast ABC with ABM
- Discuss the benefits that may arise from using ABM and the problems that may be encountered in its use
- Explain the concept of value-added (VA) and non value-added (NVA) activities
- Discuss the problems that may arise with the implementation of the VA/NVA distinction.

### **24 Business process re-engineering**

Syllabus reference 4b

- Explain the main features of business process re-engineering (BPR)
- Discuss whether and how BPR could improve performance
- Discuss Hammer's contention that BPR will only realise its full potential if carried out for the whole organisation
- Discuss the problems that might arise in adopting BPR and possible approaches to minimise the problems
- Discuss the evidence that BPR has only been successful in a minority of implementations
- Contrast BPR with ABM.

### **25 Behavioural and organisation issues**

Syllabus reference 4e, 4g

- Explain how performance measures interact with performance management, particularly the issue of 'what you measure is what you get'
- Explain how performance measures and targets can be

used to motivate individuals and discuss the problems that may arise

- Discuss whether and how participation in the target-setting process may improve performance
- Discuss the role of organisational culture and the style of management in managing performance.

### **26 Value-for-money and not-for-profit organisations**

Syllabus reference 4c

- Explain the concept of value-for-money
- Distinguish not-for-profit organisations from commercial organisations, in particular in relation to their mission and objectives
- Explain techniques for ensuring value-for-money that may be particularly appropriate for not-for-profit organisations, such as: effectiveness audits, VFM audits, programme budgeting techniques
- Discuss the role of motivation and rewards in not-for-profit organisations.

### **27 Practical difficulties**

Syllabus reference 4h

Explain the practical difficulties that may affect an organisation's ability to manage performance effectively, including:

- actions of competitors, including new entrants
- price movements
- foreign exchange movements
- labour disputes
- supply problems
- rapid technological change.

### **28 Incentive schemes**

Syllabus reference 4i

- Explain the role of incentive schemes in encouraging high levels of performance from staff
- Outline different forms of incentive scheme, such as: individual, unit and company-wide, and different elements within a scheme, such as: cash bonuses, shares and options
- Discuss the strengths and weaknesses of different incentive schemes
- Discuss problems that may occur with incentive schemes.

Note: When studying for this paper, it will be necessary to discuss examples from a wide variety of organisations, in particular: manufacturing companies, service companies, multinational companies, financial services companies, and not-for-profit organisations.