



# **CIMA/CGMA**

# **Operational Case**

# **Study**

# **Case Book**



**Nov26-Feb27**

**DEMO**

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# Preseen Application

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- Cost structure analysis
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## Quick Analysis

### 1. Tendra Tents

Tendra is a manufacturing business.

It makes tents in its own Teeland factory, using materials such as recycled fabric, mesh, aluminium poles and zips. It then stores the finished tents at a Distribution Centre and sells them:

- Directly to customers through its website.
- Indirectly to Teeland retailers.

It also sells camping accessories online, but these are bought from other suppliers rather than made by Tendra.

#### **Business model:**

1. buy sustainable materials
2. manufacture tents
3. test quality
4. store tents
5. sell online and through retailers
6. deliver to customer.

The key to success is not just “sell more tents.” It is to sell the right mix of tents at a price that covers their cost while protecting Tendra’s sustainable, quality brand.

#### **The main success factors are:**

- **Strong products:** tents must be durable, waterproof, easy to use and suited to different customers.
- **Sustainability:** recycled materials, ethical suppliers and low waste are central to why customers choose Tendra.
- **Quality control:** every tent is tested for rain, wind, zips and seams. A poor-quality tent would damage the brand quickly.

- **Cost control:** materials are expensive and volatile. Tendra must reduce waste and control labour and production costs.
- **Good product mix:** Explorer and Elite tents generate much stronger profits than Essential Solo.
- **Website performance:** about 70% of revenue comes from the website, so online recommendations, customer experience, delivery and returns are vital.
- **Managing seasonality:** sales peak in spring and summer, but production is spread across the year. Tendra must build enough inventory without tying up too much cash.
- **Innovation:** smart and modular tents could help Tendra compete, but they must be reliable, affordable and still environmentally credible.

## **Products and customers**

Tendra produces three tent ranges, each in three sizes.

| Range     | Positioning                                        | Customer                                            | Selling prices  |
|-----------|----------------------------------------------------|-----------------------------------------------------|-----------------|
| Essential | Accessible, easy to assemble and weather resistant | Leisure campers, couples and families               | T\$150-T\$420   |
| Explorer  | Stronger, more flexible and more durable           | Active campers and outdoor families                 | T\$270-T\$770   |
| Elite     | Premium tents for demanding conditions             | Mountaineers, serious campers and expedition groups | T\$850-T\$1,900 |

Essential is the entry-level range. Its tents focus on easy assembly, comfort and weather resistance. Essential Solo is designed for wild camping; Essential Family is for larger family groups.

Explorer is the core range. It has stronger material, double-stitched seams, storm flaps, breathable mesh, optional blackout panels and UV-resistant fabric. It is aimed at customers wanting more performance without paying Elite prices.

Elite is the premium range. It includes carbon poles, thermal linings, insulated floors and expedition-grade features. It is aimed at serious outdoor users, alpine trekkers and group expeditions.

Tendra also sells sleeping bags, mats, sleeping pads and rucksacks. These accessories are bought from suppliers rather than manufactured, and are sold only through the website.

### **Prices and channel strategy**

Tendra charges more on its website than through retailers.

Retailers receive discounts of:

- 15% on Essential.
- 18% on Explorer.
- 20% on Elite.

For example, Elite Basecamp is T\$1,900 on the website and T\$1,520 to retailers. This gives retailers room to make a margin, but it means Tendra must control the cost of retailer sales carefully.

Around 70% of revenue is generated through the website. The remaining 30% is generated through Teeland retailers.

The website is important because it uses AI to help customers select a suitable tent. It also gives detailed product information, eco-credentials and assembly videos. About 75% of website sales are to customers in Teeland and 25% are to customers elsewhere in Europe.

### **Recent performance**

Tendra is profitable and growing.

| 2026 actual performance | Result     |
|-------------------------|------------|
| Revenue                 | T\$23.756m |
| Gross profit            | T\$6.945m  |
| Gross profit margin     | 29.2%      |
| Operating profit        | T\$1.669m  |
| Profit after tax        | T\$1.128m  |
| Cash balance            | T\$1.084m  |
| Inventory               | T\$3.454m  |

Revenue increased by 8.7% in 2026. This is ahead of the industry's estimated growth rate of 6.4%.

The 2027 budget expects revenue of T\$25.557m and gross profit of T\$7.659m. It assumes a 30.0% gross profit margin.

Explorer is the most important range. It is budgeted to generate T\$10.779m revenue and T\$3.580m gross profit. Explorer Family is the key product, generating T\$2.748m gross profit.

Elite has the best margins. Elite Basecamp has a gross margin of 40.1%.

Essential Solo is a concern. Its budgeted gross margin is only 5.4%, so it is highly sensitive to price discounts, material-cost increases and quality problems.

### **Production process**

All tents are made at Tendra's Production Facility in Teeland.

The main materials are recycled polyester fabric, recycled polyethylene flooring, recycled nylon mesh, recycled aluminium poles, recycled zips, recycled webbing and guy lines. Tents are packed in hemp bags and recycled cardboard.

The process is:

1. Product Development creates a 3D CAD design and 2D cutting patterns.
2. Raw Materials inspects fabric and components for strength and waterproofing, labels them with barcodes and stores them.
3. Cutting uses laser machines to cut fabric pieces from rolls.
4. Sewing creates the inner tent, rainfly, pockets, seams, zips and attachments.
5. Assembly & Testing cuts and bends poles, assembles the tent and tests every tent for rain, wind, zip and seam performance.
6. Packing places the tent in a hemp bag and recycled cardboard packaging.
7. Finished tents are transferred to the Distribution Centre.

Production is even throughout the year. Sales are not. Demand is much higher in spring and summer. Therefore, Tendra produces inventory ahead of the peak selling season.

### **Sales and distribution process**

Website orders are packed in a dedicated area of the Distribution Centre and sent directly to customers using a third-party courier.

Retailer orders are despatched from the Distribution Centre using an external logistics company. Retailers are given 30- to 60-day credit terms.

Tendra's main tension is therefore clear: it needs enough inventory to meet the summer demand peak, but too much inventory ties up cash and risks becoming obsolete as product designs change.

## 2. Key numbers

These are the most useful numbers because they can support many exam answers.

| Numbers                                                         | Importance                                             |
|-----------------------------------------------------------------|--------------------------------------------------------|
| <b>T\$23.756m 2026 revenue</b>                                  | Establishes the company's scale                        |
| <b>8.7% 2026 revenue growth</b>                                 | Shows Tendra is growing faster than the 6.4% market    |
| <b>29.2% 2026 gross margin</b>                                  | Current profitability baseline                         |
| <b>T\$25.557m 2027 budget revenue</b>                           | 7.6% planned growth                                    |
| <b>30.0% 2027 budget gross margin</b>                           | Management expects margin improvement                  |
| <b>70% website / 30% retailers</b>                              | Central sales-channel and profitability issue          |
| <b>75% of website sales Teeland / 25% Europe</b>                | Creates international website-delivery issues          |
| <b>T\$3.454m inventory</b>                                      | Large cash commitment due to seasonal sales            |
| <b>96 employees; 65 in Production</b>                           | Production is labour- and operations-focused           |
| <b>Explorer Family: T\$2.748m gross profit</b>                  | Largest individual profit driver                       |
| <b>Elite Basecamp: 40.1% margin</b>                             | Highest-margin product                                 |
| <b>Essential Solo: 5.4% margin</b>                              | Main low-margin/product-risk issue                     |
| <b>Accessories: 17.9% margin</b>                                | Website-only but low-margin range                      |
| <b>Supplier credit: 30-90 days; retailer credit: 30-60 days</b> | Important working-capital issue                        |
| <b>All suppliers in Teeland</b>                                 | Supports sustainability but may raise cost/supply risk |

### **3. Industry**

#### **Growing and competitive**

The global tent market is worth about T\$4.4bn and is growing by around 6.4% each year. Europe is the largest market, worth about T\$1.4bn.

The market is fragmented. This gives smaller specialist brands like Tendra a chance to compete through design, quality and branding. However, it also means consumers have many alternatives, including low-cost imported tents.

#### **Sustainability**

Customers, especially younger consumers, increasingly want gear that is recyclable, repairable and ethically produced. Festival tent waste has made this issue more visible.

Tendra is well positioned because recycled materials and local sourcing are already central to its business model. However, this can create higher material costs than using cheaper imported materials.

Tendra must prove its sustainability claims with measurable evidence. It cannot rely only on marketing language.

#### **Seasonal demand**

Tent sales peak in spring and summer. Demand falls in autumn and winter. It is also affected by weather, consumer confidence and outdoor-tourism trends.

This creates inventory and cash-flow pressure. Tendra produces evenly all year, so it needs to build stock before summer. If demand is weaker than expected, it may hold excessive inventory.

#### **Changing costs**

Key materials, including polyester, nylon and aluminium, have rising and volatile prices. Tendra's products are material-intensive, so raw-material price increases can quickly reduce profit.

Essential Solo is especially exposed because its gross margin is only 5.4%. A small increase in raw-material cost could remove almost all of its budgeted profit.

### **Technology issues**

Consumers increasingly want lighter, modular and smart tents. Smart features can include sensors, adaptive ventilation, solar panels, charging, lighting and security systems.

Tendra is already developing modular tents and smart tents. This could create growth and premium pricing opportunities.

However, it also requires research and development, electronics suppliers, software expertise, testing, customer support and more complex quality control. Tendra must ensure that technology improves customer value without making tents too expensive, unreliable or environmentally unsustainable.

## Core activity A Discuss costing information to support differing needs of the business

### I can discuss appropriate technologies to gather data for costing purposes, from digital and other sources

Tendra already has useful digital sources of data. The company uses CAD tools to create 3D tent designs and convert these into 2D patterns. These patterns are fed into cutting software, which minimises cutting wastage. This system can provide reliable data on the square metres of fabric required for each model, the quantity of material waste, and the machine time used in cutting. This is valuable because raw materials are the largest element of the cost of a tent. For example, raw materials make up T\$121.50 of the T\$208.93 standard cost of an Explorer Solo.

The Raw Materials Department uses barcodes for each roll or component received. A barcode-based inventory system should record the supplier, batch, quantity received, quantity issued to production, price paid and inspection result. This would improve material costing because Tendra uses several different materials, including recycled polyester, recycled polyethylene, nylon mesh, recycled aluminium poles and hemp packaging. It would also make it easier to trace defects back to a particular delivery or supplier.

Production data should be captured from the four production departments: Cutting, Sewing, Assembly & Testing and Packing. Employees could use shop-floor terminals, barcode scans, or tablets to record labour time, machine time, completed units, defective units and rework. This would allow actual costs to be compared with standards. It would also identify where inefficiency occurs. For example, excessive sewing hours may indicate difficult designs, training problems or equipment faults, while high failure rates in Assembly & Testing may suggest weaknesses in earlier production stages.

Tendra should also integrate these systems through an ERP or cloud accounting system. The ERP system would link purchasing, inventory, payroll, production, sales and finance data. This is important because current cost information is likely to be held in different departments. Without integration, the Finance Department may know the total spend on materials but not whether a particular tent model, supplier or production department is responsible for a cost increase.

Non-digital information is also important. Production supervisors should record the cause of scrap, rework, idle time and unusual material losses. Engineers and maintenance staff should report machine breakdowns and repair time. Supplier meetings can provide information on expected price increases and supply risks. This qualitative information is needed to explain cost variances; a system can identify that a variance exists, but it cannot always explain why it occurred.

## **I can discuss different costing methods used to produce information**

### **Standard costing**

Tendra currently uses standard costing. It has standard cost cards, and standards are reviewed annually. The Explorer Solo cost card shows standard quantities, prices and labour hours for materials, labour and overheads.

Standard costing is useful because Tendra has repeated production processes. Every tent goes through cutting, sewing, assembly and testing, and packing. Management can therefore estimate the normal amount of material, labour and overhead required for each model. Actual costs can then be compared with standard costs to produce variances.

For example, if recycled polyester costs more than expected, Tendra will have an adverse material price variance. If more fabric is used than the standard allows, it will have an adverse material usage variance. The latter may result from poor cutting patterns, defects, employee error or material quality problems. This would give managers a reason to investigate the cause rather than merely accepting higher total costs.

The weakness is that Tendra reviews standards annually even though material costs are described as volatile. Annual standards may become outdated if supplier prices change, if new designs are introduced, or if the level of expected waste changes. Standards should be reviewed more frequently for important materials and for products undergoing redesign.

### **Absorption costing**

Tendra also uses absorption costing. Production overheads are allocated and apportioned to production cost centres and then absorbed using direct labour hours. This means that both variable and fixed production overheads are included in the cost of each tent.

Absorption costing is essential for financial reporting and inventory valuation. Tendra produces evenly throughout the year despite sales peaking in spring and summer. It therefore holds finished goods inventory before the selling season. At 30 June 2026, total inventory was T\$3.454m. Including fixed production overhead in inventory ensures that the cost of goods is matched with the revenue earned when the tents are eventually sold.

Absorption costing is also useful for long-term pricing. In the long term, sales revenue must recover fixed factory costs as well as direct costs. A product price based only on materials and labour could appear profitable while failing to cover its share of maintenance, production management and factory costs.

### **Marginal costing**

Marginal costing separates variable costs from fixed costs. It is useful for short-term decisions because it focuses on the additional cost and contribution arising from an extra unit or order.

For example, Essential Solo has a website price of T\$150 and a retailer price of T\$127.50. Its variable production cost is T\$98.55, made up of T\$66.50 materials,

T\$22.80 direct labour and T\$9.25 variable overhead. Before distribution and selling costs, the website sale generates a contribution of T\$51.45 and the retailer sale generates a contribution of T\$28.95.

This information would be useful if Tendra received a one-off order during a period of spare capacity. If the order contributes towards fixed costs and does not displace more profitable normal sales, it may be worth accepting. It is particularly relevant because Essential Solo's full-cost margin is only 5.4%, giving little protection against cost increases or additional discounts.

Marginal costing should not be used as the normal basis for pricing. Fixed costs will still need to be covered over time. Tendra must avoid continually selling at a price that only covers variable costs, especially because it has substantial fixed production and distribution costs.

### **Activity-based costing**

Activity-based costing, or ABC, would identify the activities that create overhead and allocate costs using more appropriate cost drivers. This is relevant because Tendra makes products with very different complexity. An Essential Solo is lightweight and has a simple quick-pitch design, whereas Elite Basecamp has two bedrooms, insulated floors, carbon poles and advanced materials.

Under Tendra's present system, both products receive overhead largely according to direct labour hours. This may be inaccurate. More complex products may require more design work, materials inspection, machine setup, quality testing, rework and customer support, even where the increase in direct labour time is relatively small.

ABC could use cutting-machine hours for cutting costs, sewing hours for sewing costs, number of tests or testing hours for Assembly & Testing costs, number of deliveries or inspection batches for Raw Materials costs, and number of customer orders for website fulfilment costs. This would make product costs more realistic.

### **Target costing and lifecycle costing**

Target costing would be useful for Tendra's planned smart and modular tent products. Management should start with the market price customers are willing to pay, deduct the profit margin it requires, and then calculate the maximum cost that the new product can incur. Product Development, Purchasing and Production would then work together to design a product that meets this target cost.

Lifecycle costing is also useful for new products. Smart tents could create costs before production, such as research, electronics suppliers, software development and testing. They could also create costs after sale, such as customer support, repairs, warranties and end-of-life recycling. Lifecycle costing prevents Tendra from approving a product simply because its initial manufacturing cost appears acceptable.

**I can compare and contrast different costing methods and systems (including digital costing systems) to determine the most suitable for use by the organisation**

No single costing method meets all of Tendra's needs.

Standard costing is the most suitable method for routine operational control. Tendra has repeatable production processes and detailed standard cost cards. Variance analysis can help the heads of Cutting, Sewing, Assembly & Testing and Packing control costs and investigate inefficiency.

Absorption costing is the most suitable method for financial statements, inventory valuation and long-term product pricing. This is especially important because Tendra manufactures for inventory and has T\$3.454m of inventory at the year end. It ensures that fixed production overhead is included in the cost of tents held for sale.

Marginal costing is more suitable for short-term decisions. It would help management assess special orders, promotions, temporary price reductions and the best use of spare capacity. It should be used alongside absorption costing, not instead of it.

ABC would be the best development for management decision-making. Tendra's current labour-hour basis is unlikely to reflect the true cost of the diverse product range and sales channels. ABC would be most beneficial for the more complex Elite products, smart tents, modular tents, and the comparison of website and retailer profitability.

Tendra should therefore retain its existing standard and absorption costing system, because it is useful and already embedded in the business. It should improve it with more frequent standard reviews and with ABC analysis for complex products and sales channels. A digital ERP system would make this practical by collecting data automatically from CAD, barcode, production and sales systems.

## **I can discuss the cost information required for digital cost objects**

A digital cost object is something digital whose cost and profitability management wants to measure. At Tendra, the most important digital cost object is the website. The website is a major sales channel, generating approximately 70% of revenue. It also uses AI to help customers select a suitable tent.

The website should not be treated as a costless alternative to retailers. It has its own costs: website design and maintenance, AI software and licences, hosting, cybersecurity, online marketing, payment processing, customer-service staff, direct-order packing, courier fees, returns and refunds.

Tendra should calculate profitability by website order, product, customer type and country. This is important because 75% of website sales are made in Teeland and 25% are made to other European countries. International website orders may have higher delivery costs, different returns patterns and additional customer-support costs.

The AI recommendation tool should also be assessed as a separate digital cost object if its cost is material. Relevant costs include software development, licences, data processing, maintenance and staff support. Its benefits could include higher conversion rates, reduced returns and better matching of customers to suitable products. The Finance Department should compare these benefits with the cost of the tool.

Digital information should also be used to compare the website with retailer sales. Retailers receive lower selling prices and 30- to 60-day credit terms. However, website sales require individual order processing and courier delivery. The company needs to know which channel generates the greatest contribution after its own specific costs, rather than assuming that the highest selling price gives the highest profit.

## **I can discuss quality costing**

Quality costing is important because Tendra's brand depends on durability, performance and sustainable production. A tent that leaks, fails in wind, or has faulty zips would not only create a repair cost; it would damage the company's reputation with customers who have chosen it for quality and eco-credentials.

Tendra already incurs prevention costs. These include using established sustainable suppliers, inspecting materials on arrival, using CAD systems to minimise errors and waste, and designing products with durable materials. Prevention costs are incurred to stop defects occurring in the first place.

Tendra also incurs appraisal costs. These include visual and mechanical inspection of raw materials, tensile testing, waterproofing tests, and the rain, wind, zip and seam tests performed on every completed tent. These costs identify defects before tents reach customers.

Internal failure costs occur when a defect is found before sale. Tendra states that failed tents are repaired or recycled. The cost of repair labour, replacement

materials, retesting, scrap and recycling should be recorded by product and defect type. This would show whether specific tent models or production stages are causing repeated problems.

External failure costs occur after the customer receives the product. They include returns, warranty repairs, replacements, complaint handling, refunds, lost repeat sales and reputational damage. The pre-seen does not provide figures for these costs, but Tendra should collect them because they may be significant and are likely to be more damaging than internal failures.

Tendra should produce a quality-cost report by product and department. For example, if Explorer Solo has repeated zipper failures, management can compare the cost of better supplier quality or improved sewing training with the cost of rework and customer returns. The aim should not be to minimise inspection costs in isolation. Spending more on prevention may reduce much larger failure costs.

### **I can discuss the cost information required for environmental costing**

Environmental costing is particularly relevant because sustainability is central to Tendra's mission and product proposition. The company uses recycled polyester, recycled polyethylene, recycled nylon mesh and recycled aluminium. It uses hemp bags, recycled cardboard and water-based inks. It also sources suppliers in Teeland to reduce its carbon footprint.

The Finance Department should capture the additional purchase cost, if any, of sustainable and certified materials. However, it should not judge suppliers solely by purchase price. Local sustainable suppliers may reduce transport emissions, supply-chain risk and reputational risk. These benefits are relevant to Tendra's long-term strategy and should be considered alongside the material price.

Environmental costs should also include fabric waste, scrap, recycling, energy consumption, packaging and delivery emissions. CAD and cutting software are valuable because they can measure material usage and waste by tent design. This information can help Product Development redesign a product to use less fabric or reduce offcuts without compromising durability.

Tendra should report environmental information by product. Useful measures include kilograms of recycled material per tent, cutting waste per tent, proportion of waste recycled, energy used per unit, packaging weight, emissions from delivery and the number of products repaired rather than discarded.

This information is needed for both internal decision-making and external credibility. If Tendra markets a tent as eco-friendly, it should be able to support that claim with measurable evidence. Environmental costing would also help management identify designs that are both expensive and environmentally inefficient, allowing it to improve profitability and sustainability at the same time.

## Core activity B Discuss budget information for the purposes of planning and control

### I can discuss the use of appropriate technologies to gather data from digital and other sources for budget preparation

Tendra should use an integrated budgeting system linked to its sales, production, purchasing and finance systems. This would allow the Finance Department to prepare the budget using current information rather than relying mainly on historic figures.

Website data is particularly important. Around 70% of Tendra's revenue is generated through the website. The website also uses AI tools to help customers choose a tent. Website analytics can provide information on customer searches, conversion rates, baskets abandoned, product preferences, promotional performance, returns and demand by country. This would help Tendra prepare a more reliable sales budget by tent model and market.

The 2027 budget already demonstrates the value of sales-channel information. Tent sales through the website are budgeted at T\$13.713m, while tent sales through retailers are budgeted at T\$7.644m. Accessories, worth T\$4.200m of budgeted revenue, are sold only through the website. Therefore, total budgeted website revenue is T\$17.913m, or approximately 70% of total revenue. The budget should be supported by detailed evidence that the website can generate this level of traffic, conversion and repeat purchasing.

Retailer data is also necessary. Tendra sells through retailers in Teeland, although not every retailer stocks the full range. The sales budget should be based on retailer orders, previous sales by retailer, expected promotional activity, stock held by retailers and payment history. This is more reliable than applying one general growth percentage to all retailer sales.

The barcode system in Raw Materials can provide data for the materials budget. It should show quantities received, issued to production, held in inventory, rejected during inspection and wasted in production. This is important because raw materials are a large cost for each tent and because Tendra uses several sustainable materials. For example, Explorer Solo has a raw-material standard cost of T\$121.50 out of total production cost of T\$208.93.

CAD and cutting software should provide information for production and material budgets. The software already converts designs into cutting patterns and aims to minimise waste. It can provide the expected fabric requirement and material wastage for each tent model. This is particularly useful when new products, modular tents or smart tents are developed, because historic material usage may not be relevant to a new design.

Production departments should also provide non-digital information. The Heads of Cutting, Sewing, Assembly & Testing and Packing should identify expected labour constraints, machine downtime, skills shortages, maintenance requirements and likely process improvements. Supplier discussions should provide information

about expected material-price increases, discounts for bulk orders and supply risks. The Finance Department needs this operational input because an accounting system alone cannot predict changes in supplier terms or production capacity.

### **I can explain different forecasting methods and interpret forecasting information**

Tendra should use a combination of quantitative and qualitative forecasting. No single method will be reliable enough because camping demand is seasonal and can be influenced by weather, consumer confidence, eco-tourism trends and new product demand.

Trend forecasting uses historic sales to predict future sales. Tendra's revenue increased from T\$21.860m in 2025 to T\$23.756m in 2026, an increase of T\$1.896m or 8.7%. The 2027 budget assumes lower growth of 7.6%. On the surface, this appears cautious compared with the previous year.

However, a two-year comparison is not enough evidence on its own. The business is seasonal, so annual revenue can hide major monthly changes. Tendra should use monthly sales data over several years to identify the underlying trend and avoid assuming that one year's growth will continue automatically.

Seasonal forecasting is essential. Tendra states that tent and accessory sales peak in spring and summer but decline in autumn and winter. The annual sales budget should therefore be divided into monthly or quarterly sales budgets. A monthly forecast would allow Tendra to plan inventory, cash receipts, purchasing and production more accurately.

This is important because production is undertaken evenly through the year. If sales are highly concentrated in spring and summer, Tendra must produce and build inventory before the peak selling period. The forecast must therefore be connected to an inventory budget and cash budget. Otherwise, the company may have insufficient stock in the summer or excessive inventory after the season ends.

Moving averages can reduce the effect of unusual monthly sales. For example, Tendra could use a three-month moving average to identify the normal sales pattern for Essential, Explorer and Elite tents. This may be useful where a single month is unusually high or low because of weather or a promotion. The disadvantage is that a moving average reacts slowly to rapid changes in consumer demand.

Regression or causal forecasting could be used where Tendra has enough data. Sales could be analysed against variables such as website traffic, digital advertising spend, retailer coverage, consumer income, festival attendance and tourism activity. This would be useful because the pre-seen identifies growing outdoor recreation, eco-tourism and festivals as important market drivers. However, the model would only be useful if the company has reliable historic data and understands that correlation does not always prove causation.

Qualitative forecasting should be used for new products. Tendra is developing modular tent systems and smart tents, so historic sales data will not exist. Forecasts should therefore use market research, customer surveys, product trials, retailer feedback and the knowledge of Product Development and Sales & Marketing managers. These forecasts are less objective, but they are more relevant than applying historic growth to a completely new product.

The 2027 budget indicates that Explorer is the most important tent range. Explorer revenue is budgeted at T\$10.779m, which is 42.2% of total revenue. Explorer Family alone is budgeted to generate T\$7.146m. This means a forecasting error in Explorer Family demand would have a significant effect on the total budget. Tendra should therefore forecast this product separately rather than relying on an overall company-wide sales-growth assumption.

... The rest of contents will appear in the official package.

# Introduction to the OCS exam

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## SYLLABUS CONTENT

### Session 1: Exam

- Preseen and unseen; Marking

### Session 2: Exam Techniques

- Writing style; Planning your answer

## Topic 1: Exam

### Preseen and unseen

The pre-seen material case is called 'Tendra Tents', and all the exam questions will be based on this case information. You are required by the CIMA examining team to understand the Tendra Tents business and have relevant real-life industry experience. You will be given different exhibit information on the exam day, and you **MUST** answer the questions required by the examining team based on that new information, rather than simply summarizing the Tendra Tents's pre-seen information on the exam day.

### Exam

The exam is 150 marks, and you must achieve 80 marks.

The exam is 3 hours, and it is split into 4 questions. Each question may contain multiple tasks such as writing email and report, but most questions will only include one task and several requirements. You are not required to write the format, ie email or report in the exam, you are only required to construct the body of the answer.

Nov and Feb cases are based on 'Tendra Tents', whilst May and August cases are based on another one.

### Your exam result

When you get your case study exam result you will see:

1. An overall grade (Pass/Fail).
2. A scaled score between 0–150 (80 or above represents a pass).
3. Feedback on your performance by each core activity (formerly sectional or competency feedback).

### Syllabus

- Operational level Examination Blueprint

### Marking

- You must not bring irrelevant preseen case information to your answer. The marking is based on whether you answered the requirement, ie technical knowledge.
- We expect students to have limited application of preseen case information, or real life cases to the OCS exam answer.

## Topic 2: Exam Techniques

### Exam tips

- About 8-12 paragraphs per question.
- ... The rest of contents will appear in the official package.

### Planning your answer

This is absolutely vital in the exam and make sure that when you read the ... The rest of contents will appear in the official package.

# Core activity A:

# Costing Information

**Discuss costing information to support differing needs of the business**



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## **Assessment Outcome:**

- I can discuss appropriate technologies to gather data for costing purposes, from digital and other sources
- I can discuss different costing methods used to produce information
- I can compare and contrast different costing methods and systems (including digital costing systems) to determine the most suitable for use by the organisation
- I can discuss the cost information required for digital cost objects
- I can discuss quality costing
- I can discuss the cost information required for environmental costing

**Weighting: 12%-18%**

## **SESSION CONTENTS**

**Topic 1: Absorption Costing and Marginal Costing**

**Topic 2: Activity Based Costing (ABC)**

**Topic 3: Joint and By-Product Costing**

**Topic 4: Costing digital products**

**Topic 5: Throughput Accounting**

**Topic 6 Quality Costs, Environmental Costs and Weighted Benefits Scoring**

## Topic 1: Absorption Costing and Marginal Costing

### Absorption Costing Principles (Pre-learnt paragraphs)

- **Definition:** Full production cost per unit, including fixed overheads.
- **Components of Production Cost:** Includes variable costs (materials, labor, variable overheads) and absorbed fixed overheads.
- **Overhead Absorption Rate:** Based on budgeted overhead and budgeted activity levels, ie use machine hours if it's machine intensive, or to use labour hours if it's labour intensive environment.
- **Calculation of Gross Profit:** Sales revenue minus the cost of goods sold, including absorbed fixed production overheads.
- **Adjustment for Under or Over-Absorbed Overheads:** if it's under absorption of overheads, costs of sales should be increased by this amount; otherwise, costs of sales should be reduced by the over-absorption of overheads amount.
- **Effect on Inventory Valuation:** Inventory is valued at full production cost, including absorbed fixed overheads.
- **Impact on Profit When Inventory Levels Change:** Increased inventory leads to more fixed overheads carried forward, affecting short-term MARGINAL COSTING profit reporting.
- **Long-Term Profit Consistency:** Total profit remains the same in the long term; differences arise from the timing of costs and sales.

### Marginal Costing Principles (Pre-learnt paragraphs)

- **Valuation of Inventory at Variable Costs Only:** Inventory is valued solely at variable production costs, excluding fixed costs, which are fully expensed in the period.
- **Focus on Contribution Margin:** Contribution per unit is calculated as selling price minus total variable costs (production and non-production), guiding short-term pricing and decision-making.
- **Profit Calculation Based on Contribution Minus Fixed Costs:** Net profit is determined by subtracting total fixed costs from total contribution, emphasizing the impact of sales and efficiency over production volume.
- **Comparison and Reconciliation with Absorption Costing:** Differences in profit between marginal and absorption costing arise from how inventory changes affect fixed cost allocation, requiring adjustments to reconcile.
- **Advantage - Better for Decision Making:** Marginal costing highlights the contribution margin, making it useful for short-term pricing decisions and one-off decisions.
- **Disadvantage - May Not Cover Fixed Costs:** There is a risk of selling products at a marginal contribution that fails to cover fixed costs, potentially leading to losses in the long term.

## Question practice about AC and MC

### Q1: (15minutes)

The Senior Management Team (SMT) recently met to review September's sales figures. Sales were lower than expected overall, particularly in Cetland. Jack Newman, Production Director, suggested that we should report the figures to AgRi using marginal costing so that the profit would look bigger than if we used absorption costing as we usually do. As you know that statement is incorrect, but the SMT have asked for an explanation. So, in Table 1 (attached), I have shown the standard costs for our A++ tractor range. The other ranges followed a similar pattern over the month. I would like to use these figures to explain why Jack Newman's statement is incorrect while explaining marginal and absorption costing.

#### Please prepare a report to the SMT which explains:

The differences in how profit is calculated using both marginal and absorption costing based on Table 1, and the impact of the different methods on profit in the short and long term.

(sub-task(a)=32%)

**Table 1: Standard production costs for the A++ Power range**

|                           | Model         |               |                |
|---------------------------|---------------|---------------|----------------|
|                           | Basic         | Regular       | Premium        |
| Production cost per unit: | T\$           | T\$           | T\$            |
| Variable                  | 56,644        | 75,745        | 96,973         |
| Fixed                     | 14,092        | 21,099        | 24,029         |
| <b>Total</b>              | <b>70,736</b> | <b>96,844</b> | <b>121,002</b> |

#### Notes

1. The actual fixed production overheads for September were 5% higher than budgeted.
2. Actual production was lower than budgeted but, because of the low sales, inventory of all three models in the range increased.

### Suggested Answer:

#### How Profit is Calculated Using Marginal and Absorption Costing

Marginal and absorption costing treat fixed production overheads differently, resulting in different profit figures being calculated.

#### Absorption Costing

Absorption costing determines a full production cost per unit for each type of tractor in the A++ range. This production cost includes all variable production costs (raw materials, direct labor, and variable overhead) and a portion of fixed production overhead costs. These overheads are absorbed based on the budgeted level of overhead and the budgeted level of activity, using the most appropriate method for the overhead characteristics and the production department.

Under absorption costing, gross profit is calculated as sales less the cost of goods sold, where the cost of goods sold includes fixed production overheads. The fixed production overheads are absorbed by each tractor based on a pre-determined overhead absorption rate. The profit figure is adjusted by any under or over-absorbed overhead. Under/over absorption is calculated by comparing the absorbed overheads to the actual overheads. If actual expenditure is higher than anticipated but production is lower, it suggests under-absorption. From this gross profit, non-production costs (both fixed and variable), such as selling and administration, are deducted to obtain profit.

### **Marginal Costing**

Marginal costing focuses on the variable costs of production, such as direct labor, materials, and variable overhead, to produce a contribution figure. From this contribution figure, the actual fixed costs for production for the period and non-production costs are deducted to arrive at a net profit.

### **Why Marginal Costing Profit May Be Lower Than Absorption Costing in the Short Term**

The major difference between marginal and absorption costing is in how they value each unit of production (and therefore inventory). Marginal costing values each unit produced at the marginal production cost. For example, this would be T\$56,644 for the Basic model. With absorption costing, inventory is valued at full production cost, which includes fixed production overheads. Each unit of production (and therefore inventory) absorbs fixed overheads at standard rates. When using absorption costing, the value of a Basic tractor will be T\$70,736. Inventory thus carries some of the fixed production overheads for this period into the next period (T\$14,092 for each Basic tractor).

When inventory is increasing, as it did in September, the value of fixed production overhead carried into October will be greater than the value brought forward from August into this period. Therefore, when inventory is rising, more fixed production overhead costs are carried forward, and consequently, fewer are charged this period. Jack Newman's view is incorrect. If we switched to marginal costing for September, the profit would be lower.

### **Profit in the Long Term**

In the long term, the total reported profit will be the same regardless of the method used. This is because all costs incurred will eventually be charged against sales. The differences arise only from the timing of the sales and production volumes from period to period.

... The rest of contents will appear in the official package.

# Core activity B:

# Budget

**Discuss budget information for the purposes of planning and control**



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## **Assessment Outcome:**

I can discuss the use of appropriate technologies to gather data from digital and other sources for budget preparation

I can explain different forecasting methods and interpret forecasting information

I can compare and contrast alternative approaches to budgeting to determine the most suitable for use by the organisation

I can analyse the effect on budgets of changes to variables

I can discuss the importance of budgeting

I can discuss the behavioural and governance implications of budgetary planning and control

**Weighting: 17%-25%**

## **SESSION CONTENTS**

**Topic 1: Budgeting Steps**

**Topic 2: Gathering data for budgets and Ethical considerations**

**Topic 3: Budgeting Methods**

**Topic 4: Using Budgets for Control**

**Topic 5: Forecasting**

## Topic 1: Budgeting Steps

### Principles (Pre-learnt paragraphs)

- **Budget Manual** - detailed guidelines, roles, procedures, templates, and assumptions for preparing, reviewing, and approving budgets, ensuring consistency and alignment with organizational objectives.
- **Budget Committee** - Group overseeing budget preparation and coordination.
- **Principal Budget Factor** - Key factor limiting the organization's budget (e.g., sales).
- **Functional Budgets** - Individual budgets like sales, production, purchases, and labour.
- **Master Budget** - Consolidated budget including P/L, SFP, and cash flows.

### Question practice for budgeting steps

#### Q: (15minutes)

An explanation of how you should construct the labour cost budget and the material usage and purchases budgets and the additional information that would be required.

#### Suggested Answer:

The first step in constructing the budgets is to establish the **principal budgeting factor**. In this case the principal budget factor is **sales** as we have the capacity to produce more than we can sell.

Once the **sales budget** is complete we need to determine the production budget. The production budget will be equal to the sales volume budget plus closing inventory less opening inventory.

The next budget to be determined is the material usage budget. + **(Application to the preseen processes)** Each of the departments in the factory, roasting, grinding and blending will have a material usage budget.

**(Application to the preseen/unseen)** For example, the bill of material for Milk Chocolate in the blending department shows that 90kg of cocoa butter is required to produce 1,000kg of chocolate. If we are planning to produce 200,000 bars of Milk Chocolate in the month, this will require 20,000kg of chocolate since each bar is 100g. We will therefore use 20 x 90kg of cocoa butter. We can then multiple the total quantity in kg by the cost per kg of N\$11.

The material usage budget is the basis for the material **purchases** budget. The material purchases budget will include an allowance for raw material that we plan to hold in inventory. The material purchases budget will be the

material usage budget plus closing inventory of raw material less opening inventory of raw material.

The starting point for the **labour** budget is the production budget which will detail how many of each type of bar/products we plan to produce. We can then determine the labour hours required and the labour costs using the information in the completed standard cost card. A standard cost card will be required for each product to enable separate labour cost budgets to be produced.

For each department, we need to establish the operations that will be carried out, the hours required for each operation and the grade of labour required.

The hours required for each operation will be based on a standard level of efficiency. We can obtain the information for the standard rate per hour for each grade of labour from the HR records.

(**Application** to the preseen processes) Once this has been completed we will have a labour cost budget for each department to produce 1,000kg of each type of chocolate. We can then use this information to calculate the total labour costs for each period depending on the production requirements in the period.

**Tutorial note:** Please do recap the advantages of budgets and the difference between functional and master budget\* knowledge.

\*A Functional budget is a budget of income and/or expenditure which applies to a particular function. When all the functional budgets have been prepared, they are summarised and consolidated into a master budget which consists of budgeted income statement; budgeted statement of financial position and cash budget.

... The rest of contents will appear in the official package.

# Core activity C:

# Performance

# Analysis

**Analyse financial and non-financial information to communicate insights about organisational performance.**



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## **Assessment Outcome:**

- I can interpret variances and KPIs, including sustainability-related KPIs
- I can discuss KPIs for different aspects of organisation performance
- I can discuss areas for performance improvement
- I can identify additional sources of information to assist with assessing organisational performance

**Weighting: 17%-25%**

## **SESSION CONTENTS**

**Topic 1: Operating Statements**

**Topic 2: Key Performance Indicators (KPIs) for Operations,  
Marketing, IT and HR**

## Topic 1: Operating Statements

### Operating (Profit) Statement under absorption costing system

|                                                            |          |
|------------------------------------------------------------|----------|
| <b>Budgeted Profit (Fixed Budget Profit) =</b>             | X        |
| Sales Volume Variance                                      | <u>X</u> |
| Flexible Budget Profit based on actual units sold          | X        |
| <b>Sales Variance:</b> Adjustment for sales price variance | X        |
| <b>Costs Variance: (Favourable=+; Adverse= -)</b>          |          |
| Material Price Variance                                    | X        |
| Material Usage Variance                                    | X        |
| Labour Rate Variance                                       | X        |
| Labour Efficiency Variance                                 | X        |
| Variable Overhead Expenditure Variance                     | X        |
| Variable Overhead Efficiency Variance                      | X        |
| Fixed Overhead Expenditure Variance                        | X        |
| Fixed Overhead Capacity Variance                           | X        |
| Fixed Overhead Efficiency Variance                         | <u>X</u> |
| <b>Actual Profit=</b>                                      | X        |

## Operating (Profit) Statement under marginal costing system

|                                                            |            |
|------------------------------------------------------------|------------|
| <b>Budgeted Contribution (Fixed Budget Contribution) =</b> | X          |
| Sales Volume Variance                                      | <u>X</u>   |
| Flexible Budget Profit based on actual units sold          | X          |
| <b>Sales Variance:</b> Adjustment for sales price variance | X          |
| <b>Costs Variance: (Favourable=+ ; Adverse= -)</b>         |            |
| Material Price Variance                                    | X          |
| Material Usage Variance                                    | X          |
| Labour Rate Variance                                       | X          |
| Labour Efficiency Variance                                 | X          |
| Variable Overhead Expenditure Variance                     | X          |
| Variable Overhead Efficiency Variance                      | X          |
| <b>Actual Contribution=</b>                                | X          |
| - Fixed Costs                                              | <u>(X)</u> |
| Budgeted Fixed Costs                                       | X          |
| Adjustment for Fixed Costs Expenditure Variance            | X/(X)      |
| <b>Actual Profit=</b>                                      | X          |

## Operating (Profit) Statement (Pre-learnt paragraphs)

- The statement is prepared using absorption costing system because it starts with budgeted profits. (marginal costing system if budgeted contribution is started with).
- Sales volume variance is adverse/favourable, this means less/more products sold. This is because ....
- Price variance is adverse/favourable, this means lower/higher selling price was set. This is because ....
- Costs variance is adverse/favourable, this means more/less costs were spent. This is because ....

## Question Practice for Operating statement

### Q: (22minutes)

Molly Patel (Operations Director) will be conducting her six monthly appraisal with each of the hotel managers over the next two weeks. Molly has asked for a summary of performance for each hotel for the first six months of the year.

Yesterday, Joe Perez, your fellow Finance Officer, prepared a schedule for Hotel 1, which includes two statements for the six months to 30 June 2016 a reconciliation of the budgeted to actual profit; a reconciliation of operating profit to operating cash flow for both actual and budgeted performance.

In March a new eco-neutral hotel called Envirohotel opened one street away from Hotel 1. It has a fantastic restaurant with a world-class chef. As a result of the increased competition, Hotel 1's manager, Tara Gomez, has changed the complimentary toiletry products to a luxury brand, we publicise this on our website. A major redecoration project started in April, a year ahead of schedule, after approval from Managing Director John Hayes.

### Required:

In preparation for her appraisal session with Tara Gomez, Molly has requested an explanation of what Joe's operating statement shows about the performance of the hotel, with possible reasons for the variances.

**Attachment:** Operating statement for the six months to 30 June 2016

|                                                 | <b>Room<br/>revenue<br/>stream<br/><br/>M\$000</b> | <b>Bar and<br/>restaurant<br/>Income<br/>stream<br/><br/>M\$000</b> |
|-------------------------------------------------|----------------------------------------------------|---------------------------------------------------------------------|
| Budgeted operating profit                       | 548                                                | 68                                                                  |
| Occupancy volume contribution variance          | (85)                                               |                                                                     |
| Bar and restaurant volume contribution variance |                                                    | (42)                                                                |
| Room revenue rate variance                      | 60                                                 |                                                                     |
| Bar and restaurant revenue rate variance        |                                                    | (18)                                                                |
| Variable costs variance                         | (8)                                                | -                                                                   |
| Fixed costs variance                            | (13)                                               | -                                                                   |
| Actual operating profit                         | 502                                                | 8                                                                   |

Budgeted operating profit included above is 50% of the budgeted operating profit for the year for each of the room revenue and bar and restaurant income streams

The actual level of occupancy in the hotel for the six months was 82%

The proportion of guests using the bar and restaurant facilities was 50%

Budgeted contribution per room occupied has been used to calculate the occupancy volume contribution variance Budgeted bar and restaurant contribution per guest has been used to calculate the bar and restaurant volume contribution variance.

### **Suggested Answer:**

The operating statement shows that actual operating profit was significantly lower than budgeted from both the room revenue and bar and restaurant income streams.

#### **Room revenue:**

In respect of the room revenue income stream the largest factor to affect operating profit is the occupancy of the hotel, as shown by an occupancy volume contribution variance of M\$85,000 adverse. Actual occupancy was 82% compared to the budget of 90%. It's likely that this is a result of the new eco-neutral hotel opening nearby which has possibly taken some of our potential guests. Alternatively, because this statement is for the first six months of the year only it's possible that this rate of 82% is representative of this time of the year and there will be a seasonal improvement in the rate for the second half.

Despite the reduction in the room occupancy level, the average revenue achieved per room has increased. This is evidenced by the favourable room revenue rate variance of M\$60,000. On average the rooms occupied have been sold at above the budgeted average rate. This could be because of the time of the year in that we would expect a higher rate in the first six months.

The variable cost variance is adverse and means that more was spent per room than budgeted on breakfast service, laundry, house-keeping, or possibly there has been a greater proportion of variable staffing used. One aspect of this will be the upgrade in the toiletries provided free in the bedrooms which will have increased the house-keeping costs per room occupied. Possibly there have also been price increases that weren't budgeted; this needs to be investigated further.

Fixed costs are also higher than budget. Fixed costs are not affected by occupancy so the adverse variance of M\$13,000 is the result of an increase in expenditure. The redecoration of the hotel is likely to be the reason for this. The project has been brought forward by a year and therefore will not have been included in the original budget.

#### **Bar and restaurant:**

The adverse volume contribution variance measures the effect on contribution of less guests using the bar and restaurant facilities. We

budgeted for 60% of guests to use them and the actual proportion of guests using them was 50%. In addition our occupancy was only 82% compared to the budget of 90%

Bar and restaurant revenue is also lower than budgeted for the actual level of usage, as shown by the adverse rate variance. This means that the average revenue earned per guest is lower than that budgeted. Perhaps the new eco-neutral hotel restaurant is attracting our guests, the result being that they are spending less on food and beverages in our bar and restaurant.

The costs incurred by the bar and restaurant facility are in line with the budget as there are no cost variances here.

... The rest of contents will appear in the official package.

# **Core activity D: IFRS, Taxation, Corporate governance, Ethics**

**Apply relevant financial reporting standards and corporate governance, ethical and tax principles**

Accounting  
Practise  
Center



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## **Assessment Outcome:**

- I can apply relevant IFRS in a given context, to facilitate the preparation of financial statements
- I can discuss the principles of corporate governance and ethics
- I can identify the impact of tax regulation on transactions, decisions and profits

**Weighting: 7–13%**

## **SESSION CONTENTS**

**Topic 1: IFRSs**

**Topic 2: Taxation**

**Topic 3: Corporate governance**

**Topic 4: Ethics**

## Topic 1: IFRSs

### IAS 2 Inventory



#### Top Tips:

This topic came up quite frequently in the case study exam. Here is the typical style of questions may be asked in the exam:

1. The general rule of how to value inventories.
2. Whether the changes in cost valuation method is allowed, ie, changes from FIFO to average cost method. This should be linked with IAS 8 Accounting policies change knowledge.
3. Damage to inventories and how to determine its value. The key part here would be to determine its net realisable value. I have attached a question here.

#### Inventory valuation model answer

- Per IFRS inventory, the principle about inventory valuation is that inventories should be valued at the lower of cost or net realisable value (NRV).
- The costs which must be included in the costs of inventories are: the purchase price; import duties; delivery costs etc.
- Any trade discounts that we receive are deducted from the cost.
- If the inventory is produced by us, the total production costs such as materials, labour and production overheads should also be included.
- Costs which should not be included in the inventory valuation and should be expensed to the P/L are abnormal waste, general storage costs and selling costs.
- The NRV is determined by using the expected selling price of the product (please name the product according to the unseen in the exam) and to subtract the costs to sell and complete the product. The selling price can be found in the quotation to the customer.

## Question practice for IAS 2

### Q: (12minutes)

David Hand, Production Manager, has just given me a list of the items damaged by the storm last week. David believes that about half of the cedar hives are a complete write off but that, with some work, the balance can be made serviceable and sold, although at about half the price of a perfect hive. A fork lift truck has also been damaged but, although badly dented and scratched, is still as safe and functional to use as before the storm.

All of the damaged cedar hives finished goods inventory had been included in our inventory count on 28 February 2017. Thomas wants to know how both the damage to the inventory and the fork-lift truck will be reflected in our financial statements for the year ended 28 February 2017. Given that we now do not have any finished goods inventory of cedar hives, we need to produce as many cedar hives as we can. We have orders for 450 cedar box hives from important customers that must be shipped next week.

### Required:

How the damage to the finished goods inventory will affect our financial statements for the year ended 28 February 2017.

### Suggested Answer:

The fundamental principle of IAS2: Inventory, is that inventory should be stated at the lower of cost and net realisable value (NRV). The storm has caused a physical deterioration in the cedar finished goods inventory and therefore it is likely that NRV is less than cost.

Indeed, at least half of our cedar box and slatted hives are now worthless and therefore these should now be excluded from the valuation of the stock counted inventory. The effect of this is that our finished goods inventory value will be lower than would otherwise have been the case.

This has the effect of increasing the cost of sales for the year ended 28 February 2017 as closing inventory will be lower than it should be. In effect the inventory will be written off, which will reduce profit for the year, as this is wasted production.

For the rest of the inventory which can be salvaged we need to consider its NRV. Given that we are likely to be able to sell for half of our normal price, NRV will be lower than cost.

NRV is the estimated sales price less estimated costs of completion less estimated costs necessary to make the sale. The estimated selling price is going to be much lower than our usual price: a good estimate would be the price any of our competitors charge for nonperfect products (assuming they do).

Alternatively Jacinta, Joseph or Toby may already have a price in mind; ultimately it will depend just how damaged the hives are. The estimated costs of completion will be the costs of making the hives serviceable. This will include any materials required and labour costs. The estimated costs necessary to make the sale will be the cost of the usual packaging, distribution costs and any other costs that might need to be incurred in order to sell the damaged hives.

The effect in our financial statements for the year ended 28 February 2017 that the profit in the profit or loss and the inventory in the current assets of the statement of financial position are lower than before, but they are still higher than if the stock is worthless.

... The rest of contents will appear in the official package.

# Core activity E:

# Short Term Decision Making

**Analyse information to support short-term decision making**



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## **Assessment Outcome:**

- I can discuss relevant costs and benefits
- I can apply appropriate techniques used to support short-term decisions
- I can discuss appropriate techniques to support short-term decisions where there is risk and uncertainty
- I can discuss financial, non-financial and sustainability-related factors that could influence short-term decisions
- I can identify additional sources of information to assist short-term decision making

**Weighting: 17%-25%**

## **SESSION CONTENTS**

**Topic 1: Relevant Costs Application**

**Topic 2: Linear Programming**

**Topic 3: Cost Volume Profit (CVP) Analysis**

**Topic 4: Decision Making under Risks and Uncertainty**

## Topic 1: Relevant Costs Application

In the OCS exam, the exam question may ask you to make a decision based on relevant costs analysis. Typical questions will include:

1. Make or buy decision (commonly tested)
2. Discontinued/shut down decision (commonly tested)
3. One limiting factor analysis (rarely tested)
4. Further processing decision (rarely tested)
5. Accept or Decline contracts (commonly tested)
6. Minimum pricing decision: this is just based on relevant cost (rarely tested)

### 1. Make or Buy (Outsourcing) Decision

#### Theory marks:

- A make or buy decision is a decision made by management on whether to make our products internally or buy them from the market.
- From a financial perspective, the relevant costs of the decision are the incremental costs resulting from making or buying the products.
- The incremental costs of buying in the products will be the purchase price of the supplier.
- The incremental costs of making the products will normally be the variable costs of production on the assumption that our fixed costs will remain unchanged whether the products are manufactured internally or purchased externally.
- If there is no spare capacity for making the products, the costs of making the products should also include the opportunity cost which arises from the lost benefits by not producing another type of product.

#### Application:

Be careful if the question has also included the limiting factor such as labour hours, we need to determine what is the lowest incremental cost of buying (costs to make minus costs to buy) per limiting factor (divide by the number of labour hours).

#### Other factors to consider:

- Whether the supplier is able to supply the products to the quality standards that we require. + (Apply to preseen: This is very important to us as our reputation relies on the quality of the products-in most cases in the OCS exam.)
- Whether the supplier is able to produce the products on time. (*This becomes more serious if the supplier is based overseas*) . + (Implication: Failure to meet delivery times would result in lost sales for our company).

- Does the supplier adopt similar corporate and social responsibility principles as our company? +(Preseen: in some preseen material, we may require our suppliers to follow our code of conduct. If this is the case, you can use the following sentence: As part of our corporate and social responsibility, we require any supplier to adhere to our supplier's code of conduct. If this is not the case, you can simply explain the impact of this on our reputation.)
- Whether the supplier is financially stable. If the supplier failed, this would result in lost sales whilst we find a new supplier.
- Whether the purchase price includes delivery costs. If the supplier is based overseas these could be considerable.
- (This point is not always suitable to be used.) Using an overseas supplier may affect our quality and brand. Our brand has been based on a "Made in Lowerland" badge of quality and customer may feel deceived if they discover that some of the products are made overseas. It would be unethical of us if we did not make it clear to customers where the products have been produced.
- (This point is not always suitable to be used.) Using an overseas supplier would also potentially expose us to currency fluctuations depending on the currency used in the purchase agreement.

## Question: Make or buy - Mansako

### Q: (30minutes)

We have now decided to make all of our men's accessories and women's handbags, and some of our women's accessories in-house. To avoid disappointing our customers and losing potential future business, we are considering the option of outsourcing production of the women's accessories that we can't produce in-house. The question we need to answer is which of the product groups, within our range of women's accessories, we should outsource and which we should make in house.

We have been in contact with a potential overseas supplier who has quoted some prices for the women's accessories. I have also provided details of the costs of making in-house and the labour hours (which is a binding constraint) for each of the products (See tables 1, 2 and 3 attached). After producing all of our men's accessories and women's handbags we will have 108,000 labour hours available to make the women's accessories in-house.

I would like you to provide a report, which I can discuss with Roberto Rossi, the Finance Director, which includes:

An explanation of the approach we should take to determine, from a financial perspective, which of the women's accessories to make in-house and which to outsource. Please clearly explain the figures in Table 3 and how these would be used to prioritize the accessories to make in-house. I would also like you to include details of any other factors we should consider before making a final decision.

**Table 3 – Women's accessories additional cost of purchase per labour hour**

|                                             | Purses | Technology | Pouches | Organisers |
|---------------------------------------------|--------|------------|---------|------------|
|                                             | L\$    | L\$        | L\$     | L\$        |
| Total variable costs                        | 116    | 101        | 87      | 101        |
| Purchase price from supplier                | 141    | 125        | 105     | 120        |
| Additional cost of purchase                 | 25     | 24         | 18      | 19         |
| Labour hours per unit                       | 2.80   | 2.45       | 2.10    | 2.45       |
| Additional cost of purchase per labour hour | 8.93   | 9.80       | 8.57    | 7.76       |

### Suggested Answer:

#### Make or Buy decision:

A make or buy (or outsourcing) decision is a decision made by management on whether to make our products internally or buy them from the market. From a financial perspective, the relevant costs of the decision are the incremental costs resulting from making or buying the products. The

incremental costs of buying in the products will be the purchase price of the supplier. The incremental costs of making the products will normally be the variable costs of production on the assumption that our fixed costs will remain unchanged whether the products are manufactured internally or purchased externally.

### **Determining products to make or buy:**

At first glance, it would seem that we should offer the full production of accessories to the supplier since the prices offered are all below our total production costs per unit.

However, on the assumption that our fixed production overheads will remain the same whether we make or buy, we should compare the price offered to our variable production cost per unit. Table 3 shows the excess purchase cost of buying compared to the variable cost of making.

On this basis, all of the price offered by the supplier are higher than our variable costs per unit.

We could make the decision based on the difference between the purchase price and the variable cost per unit and manufacture in-house the products with the largest difference in order to minimize the excess costs of buying-in.

On this basis, we would prioritize, for making in-house, purses and then technology, organizers and lastly pouches. However, this would fail to recognize that labour hours are a scarce resource.

We should therefore look at the additional cost per labour hour and manufacture in house the products with the largest difference per labour hour.

This would enable us to minimize the excess cost per unit of the scarce resource and therefore make the best use of our scarce resource. On this basis, we would prioritize, for making in-house, technology and then purses, pouches and lastly organizers until we have used the available labour hours.

### **Other factors:**

Before making a final decision however, there are other factors that we should consider:

Would the supplier be able to supply the products to the quality standards that we require? This is extremely important to us as our reputation relies on the quality of the products.

How reliable is the supplier? Would the supplier be able to produce the products on time? The fact that the supplier is based overseas may also result in extended delivery times. Failure to meet delivery times would result in lost sales for our company.

Does the supplier share the same ethos as us in terms of corporate and social responsibility and environmental management? As part of our corporate and social responsibility, we require any supplier to adhere to our supplier's code of conduct. To be linked with a company which fails to meet high standards in these areas would be detrimental to our business.

How financially stable is the supplier? If the supplier failed, this would result in lost sales whilst we find a new supplier. Does the purchase price include delivery costs? As the supplier is based overseas these could be considerable.

Is it a good idea to use a supplier which is based overseas? Our brand has been based on a "Made in Lowerland" badge of quality and customer may feel deceived if they discover that some of the products are made overseas. It would be unethical of us if we did not make it clear to customers where the products have been produced.

Using an overseas supplier would also potentially expose us to currency fluctuations depending on the currency used in the purchase agreement.

... The rest of contents will appear in the official package.

# Core activity F:

# Working Capital

# Management

**Discuss the management of working capital.**



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## **Assessment Outcome:**

- I can discuss appropriate sources of short-term finance and methods of short-term investments
- I can discuss how to manage and control working capital, and the impact of changing working capital policies
- I can analyse working capital ratios of the organisation and its customers and suppliers

**Weighting: 12–18%**

## **SESSION CONTENTS**

**Topic 1: General working capital management knowledge**

**Topic 2: Receivables Management**

**Topic 3: Inventory Management**

**Topic 4: Cash and Payables Management**

**Topic 5: Short Term Finance and Investments**

## Topic 1: General working capital management knowledge

### Ratios

Cash operating/working capital cycle= Inventory days + Receivable days – Payable days

Current ratio =  $\frac{\text{Current assets}}{\text{Current liabilities}}$

Quick ratio =  $\frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$

### Question practise for working capital ratios

#### Q: (22minutes)

I need to prepare a report for the next directors' meeting and I would like you to draft a couple of sections for me.

The directors would like an analysis of our working capital position at the end of June 2016 compared both with our position at the end of June 2015 and with one of our major competitors which has a year-end of April. This competitor operates concessions in large department stores and has a number of corporate contracts to supply hotels with its products.

I've pulled together the following information in respect of this:

|                       | Based on our<br>30 June 2016<br>balance | Based on<br>our 30 June<br>2015<br>balance | Based on our<br>competitor's<br>balance at 30<br>April 2016 |
|-----------------------|-----------------------------------------|--------------------------------------------|-------------------------------------------------------------|
| Inventory days        | 240 day                                 | 207 days                                   | 180 days                                                    |
| Receivable days       | 45 days                                 | 23 days                                    | 47 days                                                     |
| Payable days          | 35 days                                 | 42 days                                    | 65 days                                                     |
| Working capital cycle | 250 days                                | 188 days                                   | 162 days                                                    |

#### Suggested Answer:

#### ANALYSIS OF WORKING CAPITAL POSITION

Our working capital cycle has increased by 62 days at the end of June 2016 compared to 2015, which will have had a detrimental effect on our cash flows.

Inventory days have increased significantly. This could indicate that the marketing efforts we undertook earlier in the year have not generated the additional sales that were anticipated. We might have produced too much inventory; we now need to be careful that some of this inventory does not become past its best date and obsolete, proper inventory rotation in the warehouse is very important.

Receivable days have also increased significantly. The balance at the end of June should represent solely the amounts receivable from our department store concession partners in respect of sales made in department stores in the month of June. In 2015 receivable days of 23 days was in line with this (given that 70% of our sales comes from concessions). The fact that it is now 45 days is cause for concern. Potentially one or more of our department store partners is withholding payment and we need to ascertain why.

Payables days have decreased. This is likely due to changing some of our suppliers who perhaps have offered a shorter credit period. Alternatively it could be that we have been able to claim a prompt payment discount by paying earlier.

### **Compared to our competitor:**

In respect of comparing our position against our competitor's there are two notes of caution:

The competitor's year end is April and therefore it is entirely possible that seasonal factors will affect the comparison.

The competitor operates slightly differently in that they have corporate customers as well as concessions. This will have an impact on receivable days.

Overall the competitor has a lower operating cycle which will be beneficial for their cash flow. Inventory days are lower than ours; it's possible that because of their corporate customers the competitor does not need to hold as much inventory, possibly production is carried out to specific orders.

Receivable days are in line with our position at the end of June 2016, although given that they have corporate clients we would actually expect it to be higher than our position. Again this highlights that we have a potential issue with our receivables balances at the end of June 2016.

Payable days are higher than ours. This could be the result of extended payment terms that our competitor has negotiated with its suppliers.

Alternatively it could be that our competitor deliberately pays later and does not treat its suppliers ethically.

## Question practise for general working capital cycle

### Q: (15minutes)

She would like me to look in particular at our working capital cycle. Firstly, she wants me to suggest ways in which we could reduce the length of our working capital cycle and secondly, to consider the impact of a shorter working capital cycle on our ability to operate efficiently and on our relationship with customers and suppliers.

### Suggested Answer:

#### Reducing the working capital cycle:

The working capital cycle represents inventory days plus receivable days less payable days. The longer the working capital cycle, the longer capital is tied up and not earning a return. However, businesses need sufficient working capital to survive and therefore working capital needs to be managed to balance these two requirements. There are a number of steps that could be taken to reduce the working capital cycle as follows:

#### Inventory:

Our current inventory levels are high at F\$21 million. What is the breakdown of this between raw material, work in progress and finished goods?

We could reduce our raw material inventory holdings by reviewing slow moving stock, reorder levels and re-order quantities. In the longer term, we might also consider the use of JIT purchasing.

Better supplier relationships may also help to ensure the correct inventory is received at the right time and reduce the lead time between order and receipt of goods.

It must be borne in mind however that reducing inventory levels could result in the loss of discounts for bulk purchases and we may also incur additional costs as a result of price rises. There is also the danger of stock-outs which may result in production delays and failure to meet our customers' orders on time.

We could review our production techniques and efficiency levels with a view to reducing work in progress.

Our main production is of four standardised products. Do we need to hold such large inventories of these products? We could reduce our finished good inventory by reorganising our production scheduling and distribution methods. In the longer term, we could also consider the introduction of JIT production. We must however ensure that any changes do not affect our ability to satisfy customer demand and result in a reduction in sales.

#### Accounts payable:

We could obtain more finance from suppliers by delaying payments. This is considered by some to be unethical and could result in the withdrawal of

credit and / or future supplies. The Finance Director is concerned not to jeopardise supplier relations, we should therefore do this through negotiation with the supplier. We may however lose potential early settlement discounts or incur additional charges as a result of this policy.

### **Accounts receivable:**

Are our customers paying according to agreed credit terms or is there evidence of late payment? We could reduce the credit given to customers although this may result in a loss of sales. We could however ensure that we invoice customers and follow up outstanding amounts more quickly, without damaging customer relations. We could also offer early payment discounts to customers although we would need to evaluate whether the reduced cash payment would be outweighed by the benefit of receiving cash quicker.

Another alternative would be to factor our debts or use invoice discounting. This would generate immediate cash flow however there would also be interest costs and fees involved.

We would need to decide if these costs are justified compared to the benefits offered. We would also need to carefully consider whether factoring is appropriate since it may cause our customers to question our financial stability.

... The rest of contents will appear in the official package.

