

# Chapter 17

## DIVISIONAL PERFORMANCE MEASUREMENT

### 1. Introduction

In this chapter we will consider the situation where an organisation is divisionalised (or decentralised) and the importance of proper performance measurement in this situation.

- We will also consider the possible problems that can result from the use of certain standard performance measures.

### 2. The meaning of divisionalisation

Divisionalisation is the situation where managers of business areas are given a degree of autonomy over decision making i.e. they are given the authority to make decision without reference to senior management. In effect they are allowed to run their part of the business almost as though it were their own company.

#### 2.1. Advantages of divisionalisation:

#### 2.2. Problems with divisionalisation:



### 3. The use of performance measures to control divisional managers

If managers are to be given autonomy in their decision making, it becomes impossible for senior management to 'watch over' them on a day-to-day basis – this would remove the whole benefit of having divisionalised!

The way to control their performance is to establish in advance a set of measures that will be used to evaluate their performance at (normally) the end of each year.

These measures provide a way of determining whether or not they are managing their division well, and also communicate to the managers how they are expected to perform.

It is of critical importance that the performance measures are designed well.

For example, suppose a manager was simply given one performance measure – to increase profits. This may seem sensible, in that in any normal situation the company will want the division to become more profitable. However, if the manager expects to be rewarded on the basis of how well he achieves the measure, all his actions will be focussed on increasing profit to the exclusion of everything else. This would not however be beneficial to the company if the manager were to achieve it by taking actions that reduced the quality of the output from the division. (In the long-term it may not be beneficial for the manager either, but managers tend to focus more on the short-term achievement of their performance measures.)

It is therefore necessary to have a series of performance measures for each division manager. Maybe one measure will relate to profitability, but at the same time have another measure relating to quality. The manager will be assessed on the basis of how well he has achieved all of his measures.

We wish the performance measures to be goal congruent, that is to encourage the manager to make decisions that are not only good for him but end up being good for the company as a whole also.

In this chapter we will consider only financial performance. However, non-financial performance is just as important and we will consider that in the next chapter.

### 4. Controllable profits

The most important financial performance measure is profitability.

However, if the measure is to be used to assess the performance of the divisional manager it is important that any costs outside his control should be excluded.

For example, it might be decided that pay increases in all division should be fixed centrally by Head Office. In this case it would be unfair to penalise (or reward) the manager for any effect on the division's profits in respect of this cost. For these purposes therefore an income statement would be prepared ignoring wages and it would be on the resulting controllable profit that the manager would be assessed.

### 5. Investment Centres and the problem with measuring profitability.

As stated earlier, divisionalisation implies that the divisional manager has some degree of autonomy.

In the case of an investment centre, the manager is given decision making authority not only over costs and revenues, but additionally over capital investment decision.



In this situation it is important that any measure of profitability is related to the level of capital expenditure. Simply to assess on the absolute level of profits would be dangerous – the manager might increase profits by \$10,000 and be rewarded for it, but this would hardly be beneficial to the company if it had required capital investment of \$1,000,000 to achieve!!

The most common way of relating profitability to capital investment is to use Return on Investment as a measure. However, as we will see, this can lead to a loss of goal congruence and a measure known as Residual Income is theoretically better.

## 6. Return on Investment (ROI)

**ROI** is defined as: Controllable division profit expressed as a percentage of divisional investment

It is equivalent to Return on Capital Employed and this is one of the reasons that it is very popular in practice as a divisional performance measure.

### Example 1

Arcania plc has divisions throughout the Baltic States.

- The Ventspils division is currently making a profit of \$82,000 p.a. on investment of \$500,000.

Arcania has a target return of 15%

The manager of Ventspils is considering a new investment which will require additional investment of \$100,000 and will generate additional profit of \$17,000 p.a..

- Calculate whether or not the new investment is attractive to the company as a whole.
- Calculate the ROI of the division, with and without the new investment and hence determine whether or not the manager would decide to accept the new investment.

In the above example, the manager is motivated to accept an investment that is attractive to the company as a whole. He has been motivated to make a goal congruent decision.

Note that in this illustration we have used the opening Statement of Financial Position value for capital invested. In practice it may be more likely that we would use closing Statement of Financial Position value (which would be lower because of depreciation). There is no rule about this – in practice we could do whichever we thought more suitable. However, in examinations always use opening Statement of Financial Position value unless, of course, you are told to do differently.

However, there can be problems with a ROI approach as is illustrated by the following example:

### Example 2

The circumstances are the same as in example 1, except that this time the manager of the Ventspils division is considering an investment that has a cost of \$100,000 and will give additional profit of \$16,000 p.a.

- Calculate whether or not the new investment is attractive to the company as a whole.
- Calculate the ROI of the division, with and without the new investment and hence determine whether or not the manager would decide to accept the new investment.



In this example the manager is not motivated to make a goal congruent decision. For this reason, a better approach is to assess the managers performance on Residual Income.

## 7. Residual Income (RI)

Instead of using a percentage measure, as with ROI, the Residual Income approach assesses the manager on absolute profit. However, in order to take account of the capital investment, notional (or imputed, or 'pretend') interest is deducted from the P&L profit figure. The balance remaining is known as the Residual Income.

(Note that the interest charge is only notional, and is only made for performance measurement purposes).

### Example 3

**Repeat examples 1 and 2, but in each case assume that the manager is assessed on his Residual Income, and that therefore it is this that determines how he makes decisions.**

Note that in both cases the manager is motivated to make goal congruent decisions.

## 8. ROI vs RI

In practice, ROI is more popular than RI, despite the fact that RI is technically superior.

### 8.1. Reasons for using ROI:

### 8.2. Reasons for using RI:

When you finished this chapter you should attempt the online F5 MCQ Test

