**DIVISIONAL PERFORMANCE MANAGEMENT**

A feature of modern business management is the practice of splitting a business into semiautonomous units with devolved authority and responsibility. Such units could be described as ‘divisions’, subsidiaries or strategic business units (SBUs) but the principles are the same.

**PROBLEMS ASSOCIATED WITH DIVISIONAL STRUCTURES**

Before looking at the methods for divisional performance appraisal it is worth noting that divisional structures may result in the following problems:

* Coordination how to coordinate different divisions to achieve overall corporate objectives.
* Goal congruence – managers will be motivated to improve the performance of their division, possibly at the expense of the larger organisation.
* Head office costs – whether/how head office costs should be reapportioned.
* Transfer prices – how transfer prices should be set as these effectively move profit from one division to another.
* Controllability – divisional managers should only be held accountable for those factors that they can control. The performance of a division's manager must be appraised separately to the performance of the division. It may be difficult to determine exactly what is and what is not controllable.
* Interdependence of divisions – the performance of one division may depend to some extent on others, making it difficult to measure performance levels.

**RESPONSIBILITY ACCOUNTING**

Responsibility accounting is based on the principle of controllability, i.e. managers should only be made accountable and be assessed on those aspects of performance they can control. The controllability principle may result in the establishment of different

performance measures for the division and its manager. In practice, it can be difficult to establish which items are controllable and which are uncontrollable. For example, an increase in supplier’s prices may be seen as something that the divisional manager cannot control. However, it could be argued that the cost is controllable since the divisional manager may be able to change the source or type of supply.

**TYPES OF RESPONSIBILITY CENTRES**

There are three types of responsibility centre. Cost center, Profit center and Investment Center When assessing divisional performance it is vital that the measures used match the type of division:

**Return on investment (ROI)**

ROI is the divisional equivalent of ROCE. It shows the operating profit that is generated for every $1 of assets employed. If ROI is used to appraise the performance of the divisional manager then only the controllable elements of operating profit and capital employed should be included

 Controllable profit from operations

ROI = –––––––––––––––––––––––––– × 100

 Controllable capital employed

Note: As with ROCE, use PBIT if this is given instead of profit from operations.

Decision rule: If ROI > cost of capital (required return), then accept the project or appraise the division as performing favourably.

***Dysfunctional decision making***

There is a risk that if ROI is used as a performance measure, management may only take decisions which will increase divisional ROI, regardless of wider corporate benefits.

**Residual income**

The problems of dysfunctional behaviour and holding onto old assets can be addressed by using residual income (RI) to appraise divisional performance.

What is residual income (RI)?

Controllable profit from operations X

Less imputed interest (controllable capital employed × cost of capital) (X)

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RI X

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Note: As with ROI, use PBIT if this is given instead of profit from operations.

Decision rule: if the RI is positive:

• accept the project or

• appraise the division as performing favourably.

**Economic value added**

EVA is a measure of performance similar to residual income. However, adjustments are made to financial profits and capital to truly reflect the economic value generated by the company.

It is a measure of performance that is directly linked to shareholder wealth.

It is important to note that EVAcan be used to appraise organisation­wide performance as well as divisional performance.

**Calculating EVA**

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Net operating profit after tax (NOPAT) X

Less: adjusted value of capital employed at beginning of the year × WACC (X)

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EVA  X/(X)

**Decisionrule**: a positive EVA is favourable,since the organisation is providing a returngreater than that required by the providers of finance.

**Adjustments required**

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|  | **Change to profit** | **Change to capital employed** |
| **Depreciation and non­current assets**  | **Add** back depreciation **Deduct** economic depreciation which reflects the true value of assets during the period  | Adjust value to reflect economic depreciation and not accounting depreciation.  In addition, adjust value to reflect replacement cost of non­current assets rather than the book value. |
| **Provisions** | **Add** increase in provisions in the period, e.g. debt provisions, deferred tax provisions. **Deduct** reduction in provisions in the period. These represent over­prudence in the financial accounts. | **Add** back the value of provisions in the period  |
| **Non­cash expenses**  | **Add** back since they do not represent cash paid and may be as a result of profit manipulation and not real costs. | **Add** to retained profit at the end of the year |
| **Interest paid net of tax**, i.e. interest × (1 – tax rate)  | Interest payments are taken into account in WACC  |  |
| **Expenditure on****advertising, research****and development and****employee training** | **Add** back, i.e. capitalise the entire expense **Deduct** amortisation for the period (if mentioned) | **Increase** capital employed at the end of the year **Increase** capital employed in respect to similar add backs in previous year's investments  |
| **Operating leases**  | **Add** lease payments  **Deduct** depreciation on operating lease assets | Add present value of future lease payments. Operating leases should be treated in the same way as financial leases (i.e. capitalised) to prevent firms from using operating leases to reduce capital employed and hence increase EVA |

**What is the WACC?**

WACC = (proportion of equity × cost of equity) + (proportion of debt × post tax cost of debt)

For example, suppose that a company is 60% financed by equity which has a cost of 10% pa and 40% financed by debt which has an after tax cost of 6%

WACC = (0.60 × 0.10) + (0.40 × 0.06) = 0.084  therefore 8.4%

**Summary NOPAT calculation**

Controllable operating profit  X

**Add**:

accounting depreciation  X

increase in provisions  X

non­cash expenses  X

advertising, research and development and employee training costs   X

operating lease payments X

**Deduct**:

economic depreciation  (X)

decrease in provisions (X)

amortisation of advertising, research and development and employee training  (X)

depreciation of operating lease assets    (X)

tax charge plus tax relief on interest (interest × tax rate)  (X)

**= NOPAT**  **X**

**Evaluation of EVA**

EVA assesses the value created by managers, so is a more appropriate tool for measuring performance than a profit based measure.  However, it is not without its drawbacks.

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| **Advantages**   | **Disadvantages**  |
| EVA is consistent with NPV. Maximisation of EVA will create real wealth for shareholders | Requires numerous adjustments to profit and capital employed figures which can be cumbersome.  |
| The adjustments made avoid the distortion of results by the accounting policies in place and should therefore result in goal congruent decisions. | Does not facilitate comparisons between divisions since EVA is an absolute measure (as is RI).  |
| The cost of financing a division is bought home to the division's manager. | There are many assumptions made when calculating the WACC, making its calculation difficult and potentially inaccurate.  |
| Long­term value­adding expenditure can be capitalised, removing any incentive that managers may have to take a short­term view.  | Based on historical data where as shareholders are interested in future performance.  |

**VALUEBASED MANAGEMENT**

VBM is an approach to management whereby the company's strategy, objectives and processes are aligned to help the company focus on the key drivers of shareholder wealth and hence the maximisation of this value.

**Measuring shareholder value**

Traditionally, financial measures such as EPS and ROCE were used to quantify shareholder value. However, none of these measures directly correlates with the market value of the company (i.e. shareholder value). **VBM is an approach which takes the interests of the shareholders as its primary focus.**

VBM begins from the view that the value of a company is measured by its discounted cash flows. The idea being that value is only created when companies generate returns which beat their cost of capital. VBM then focuses the management of the company on those areas which create value. A key to this process is the identification of the drivers of value and then a concentration of effort at all levels (strategic, tactical and operational) on these drivers in order to increase the value of the firm.

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Implementing VBM

The implementation of VBM will involve four steps:

• Step 1 – a strategy is developed to maximise value.

• Step 2 – key value drivers are identified and performance targets (both short and long term) are defined for those value drivers. Targets may be developed by benchmarking against competitors.

• Step 3 – a plan is developed to achieve the targets.

• Step 4 – performance metrics and reward systems are created that are compatible with these targets. Staff at all levels of the firm should be motivated to achieve the new targets set.

Measures used in VBM

• EVA – this is the primary measure used. A positive EVA indicates value creation while a negative one indicates destruction.

• Market value added (MVA) – this is the accumulated EVAs generated by an organisation since it was formed.

• Shareholder value analysis – this is the application of a discounted cash flow technique to valuing the whole business rather than a single

potential investment.

VBM evaluation

VBM focuses on value as opposed to profit, thus focusing on the long term rather than purely the short term. This makes the organisation more forward looking. However, VBM can become an exercise in valuing everything and changing nothing. In addition, management information systems may need to be adapted to take account of the need to measure nonfinancial indicators.

The techniques available for increasing and monitoring value include:

• the balanced scorecard

• business process reengineering

• TQM

• JIT

• ABC and ABM

• benchmarking.

**TRANSFER PRICING**

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