Case 4

Essex Engineering

Topic: Performance measures,

Essex is an industrial company with three divisions. Both the Midland Division and the North Division are long established. Senior managers are concerned that these divisions have a high percentage of products that are near the end of their product life-cycle. Forecast sales increases over the next 5 years is expected to be in the region of 4-5% per annum.

The East Division was acquired in 1999 and senior managers are optimistic that this division has very good growth potential. Most of the senior managers at this division have experience of working at the other divisions.

Since 1999 the head office has ranked all divisions according to return on investment (ROI) and residual income (RI). All managers believe that the rankings are important for future promotions and career development.

A small number of other performance measures are also used by managers. These include

1. Non-productive time: Non-productive direct labour hours (percentage of total hours paid). Non-productive time includes time wasted as a result of production delays or material shortages.

2. Customers: Customer complaints (percentage of total number of customers)

3. Lead time: Time from order to delivery

These performance measures were agreed by all managers in 1999. At the time it was thought that managers should focus on only a small number of measures.

2002

The managers at the divisions provided the following information for the head office.

Selected data from the budgeted Management Accounts to 31 December 2002

	Midland Division £	Northern Division £	East Division
Sales	1,580,000	1,560,000	1,112,000
Cost data			
Controllable cost of goods sold	650,000	620,000	380,000
Non -controllable cost of goods sold	116,000	115,000	100,000
Controllable Selling general & Administrative overheads	370,000	400,000	370,000
Non-controllable Selling general & Administrative overheads	250,000	250,000	162,000
Total costs	1,386,000	1,385,000	1,012,000
Capital employed			
Total investment	1,400,000	1,440,000	850,000
Controllable investment	1,200,000	1,111,000	800,000
Sales growth 2003	4.80%	5.20%	28.00%
Sales growth 2004	4.30%	5.10%	37.00%
	1,580,000	1,560,000	1,112,000

<u>Other measures</u>

		Midland Division	Northern Division	East Division
Non-productive time: Non-productive direct labour hours (percentage of total hours paid).	2001	4%	4%	6%
	2002	4.1%	3.8%	7.5%
Customer complaints (percentage of total number of customers)	2001	1%	1.2%	5%
	2002	1.1%	1.1%	6%
Lead time: Time from order to delivery	2001	10 days	9 days	15 days
	2002	11 days	9 days	18 days

The head office has estimated that the group cost of capital is 10%

Ranking divisions in 2000
In 2000 the data on controllable and non-controllable costs and investments will be used to rank divisions.

Questions

Question 1
Based on the data provided comment on the relative financial performance of the two divisions and **discuss** how the ranking of the divisions changes if controllable and non-controllable costs and capital employed are analysed.

Question 2

Evaluate the choice of performance measures for the 3 divisions

Question 3

Identify and evaluate the difficulties faced by managers when measuring capital employed for a division.

Question 4
Discuss how using ROI can result in managers making poor investment decisions.

Question 5

Discuss the particular problems multinational companies have when evaluating the performance of divisions.

Answers

(a) See spreadsheet

(b) What assets are included - how are they valued

What assets are not controllable

What assets are idle

Should liabilities be included or excluded

Gross book value or net book value or market value

Cost of getting information for market values

(c) Behavioural problems
Examples of division with high ROI rejects good investment because ROI not quite as good. Lowers overall ROI
Company with low ROI accepts investment which improves overall ROI but gives return below cost of capital.

(d) Currency translation – manager uses local currency but head office wants results in home currency.
Changes is exchange rate can make manager look good or bad.
Problems of criticising manager for decline in exchange rate
Cultural and language barriers – limits to number of foreign managers!
Income taxes
Complicated reporting requirements
Volume of reports
Relative inflation
Legal differences can complicate evaluation
Import duties / tariffs
Management charges