Lecture 4

Divisionalisation

A division (a self contained business segment) is the most decentralised form of responsibility centre

Organisations decentralise by creating responsibility centres

Types of Responsibility Centres
(Drury 9th edition pp. 411-413; 8th edition pp. 400-402)

Cost Centres (and Revenue Centres)

Profit Centres

A big increase in managerial autonomy occurs when responsibility is given for production and sales

Investment Centres

(highest level of managerial autonomy)

responsibility for sales, costs, and investment decisions

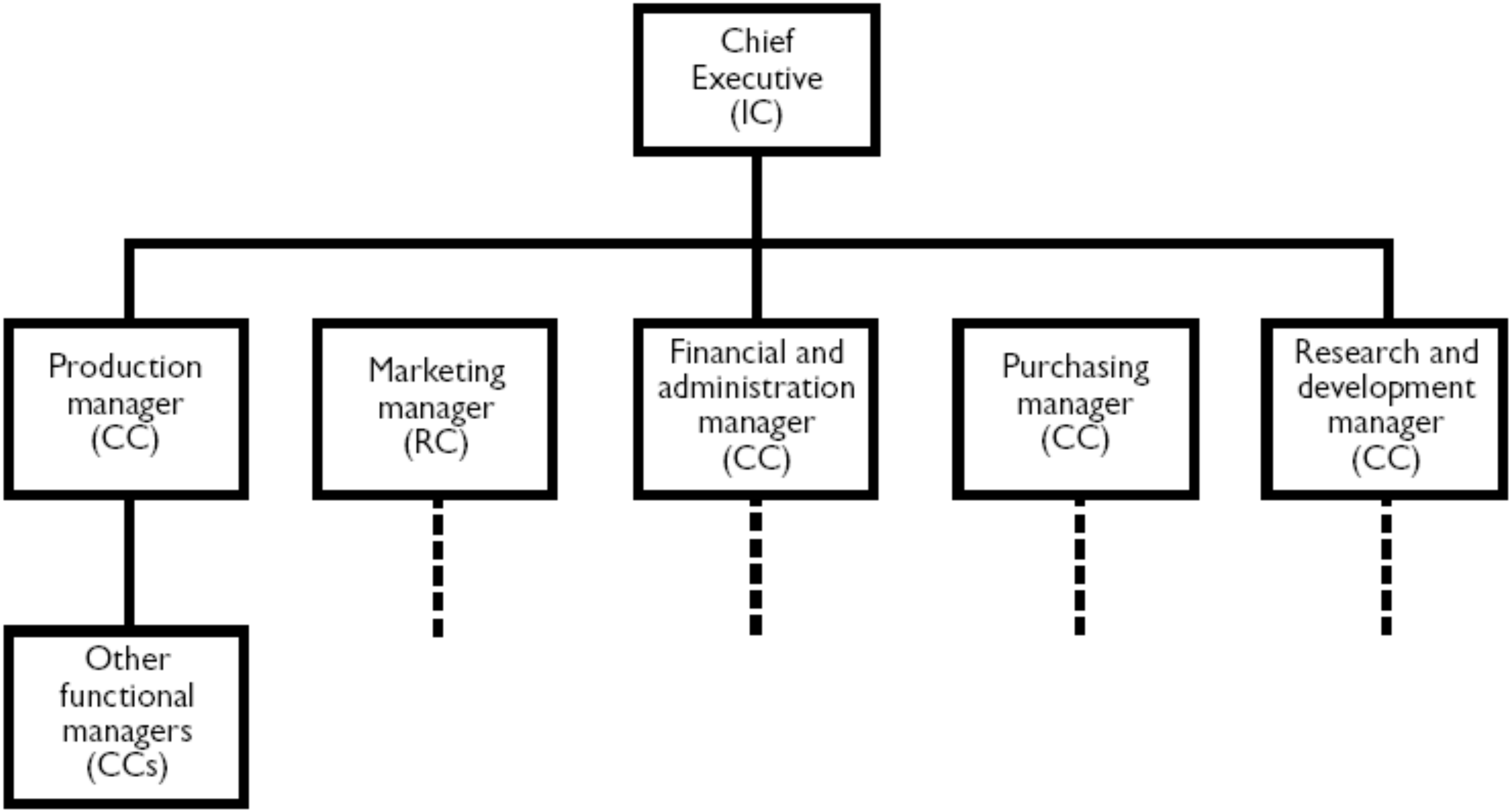
- We’ll use the term “division” to refer to all such significant “Strategic Business Units” (SBUs)
- Note that terminology is not always precise (e.g. “investment centres” may sometimes be referred to as “profit centres” in ordinary language)

KEY POINT

“The essence of decentralisation is the freedom to make decisions” Horngren

20.2a

Fig 20.1(a) Functional organizational structure



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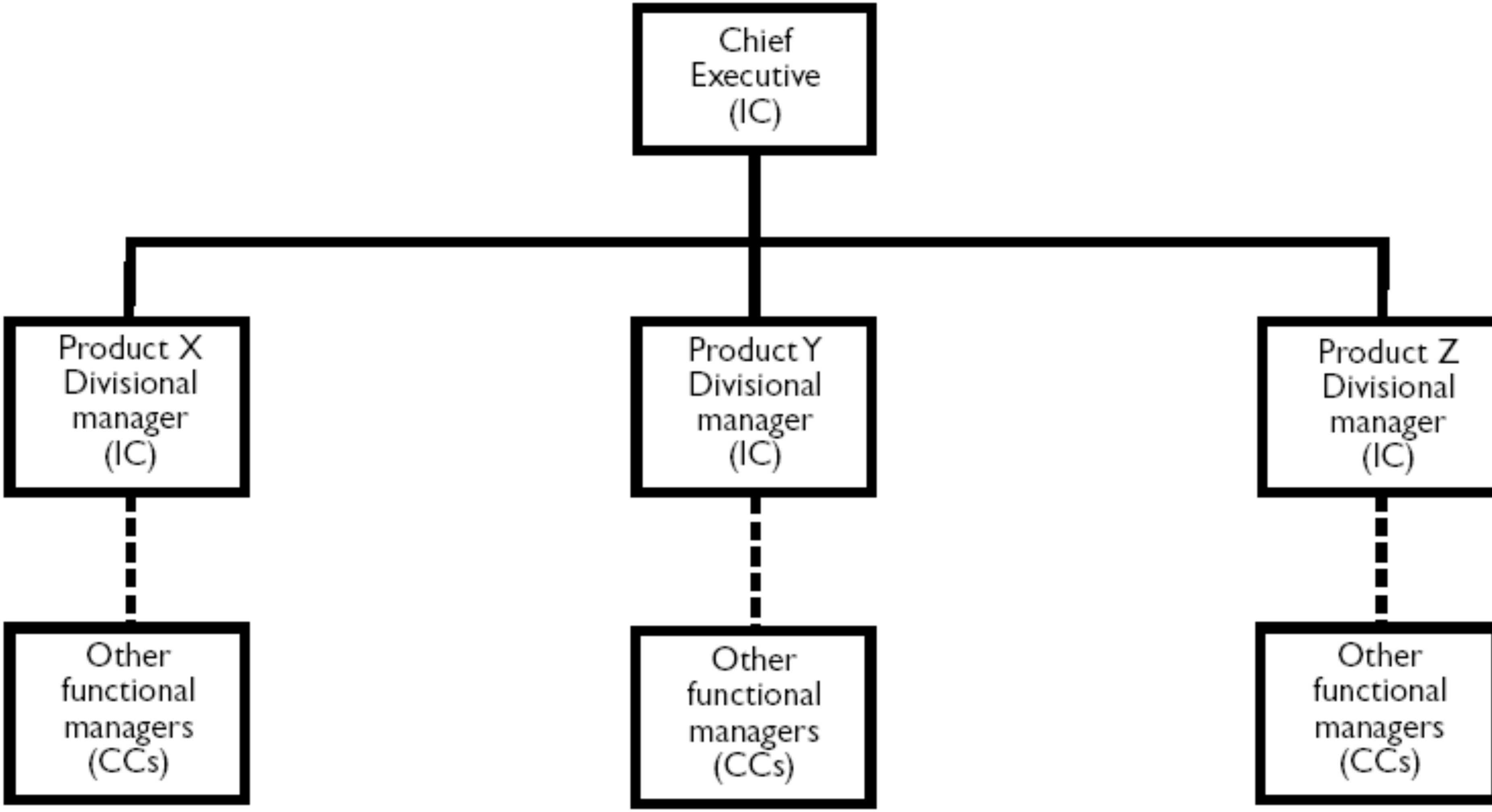
20.2b

Fig 20.1(b) Divisionalised organizational structure



IC = Investment centres, CC = Cost centres, RC = Revenue centres

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Advantages of divisionalization

- Improved quality of decisions – information specialisation
- Speedier decisions
- Increases managerial motivation
- Enables top management to devote more time to strategic issues
- Training for local managers

Disadvantages of divisionalization

- Suboptimisation and may promote a lack of goal congruence.
- May be more costly to operate a divisionalized structure.
- Loss of control by top management.

Prerequisites for successful divisionalization

- More appropriate for companies with diversified activities.
- Relations between divisions regulated??? so that no division, by seeking to increase its own profit, can reduce the profitability of the company as a whole. Easier said than done! Especially if divisions buy and sell to each other – which involves "Transfer Pricing"

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Disadvantages of decentralisation (Kaplan)

- Maximising local performance measures at the expense of the firm (dysfunctional decision making - or a lack of goal congruence)
- Friction between decentralised units
- Risk avoiding behaviour
- Misrepresentation of information
- Agency costs
- Possible duplication of functions and lack of standardisation

Measuring divisional profits

• There are strong arguments for producing two measures of divisional profitability:

- one to evaluate managerial performance

- and the other to evaluate the economic performance of the division.

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Measuring divisional profitability

• Ideally focus should be on relative measures (profitability) rather than absolute measures of profit.

Relative profitability measures:

1. Return on investment (ROI)
2. Residual income (RI)
3. Economic value added (EVA)

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Return on investment (ROI)

	Division A	Division B
Profit	£1m	£2m
Investment	£4m	£20m
ROI	25%	10%

- Division B earns higher profits but A is more profitable
- ROI is a relative measure of performance that can be compared with other investments.

Residual income (RI) = Profit - Charge for cost of capital

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Proposed investment: ROI and RI compared

(The overall cost of capital for the company is 15%)

	Division X	Division Y
(ROI of divisions at present	*25%*	*9%*
Proposed Investment	£10 million	£10 million
Profit	£2 million	£1.3 million
ROI on the proposed project	20%	13%
RI on the proposed project	= 2 -1.5	= 1.3 -1.5
	= £.5m	= £(.2)m
Managers' motivation:		
Under ROI	Reject	Accept
Under RI	Accept	Reject

RI => Goal Congruence

- The manager of division X is motivated to invest and the manager of division Y is motivated not to invest.

- RI also enables different cost of capital percentages to be applied to different investments that have different levels of risk.

- If RI is used it should be compared with budgeted/target levels which reflect the size of the divisional investment.

- ROI lends itself easily to making comparisons between investments of different size.

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Economic value added (EVA)

- During the 1990s RI was refined by a consulting firm (Stern Stewart) and registered as a trademark EVA™

- EVA = Conventional divisional profit based on GAAP
  ± Accounting adjustments
  – Cost of capital charge on divisional assets

- Conventional divisional profit based on principles outlined for measuring divisional managerial and/or economic profits.

- Adjustments intended to convert historic accounting profit to an approximation of economic profit.

- Adjustments typically include capitalization of discretionary expenses and adjustment of some non-cash accounting entries.

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Assets to be included in the investment base

- Assets to be included must be specified for ROI, RI and EVA

- To measure the managerial performance only controllable assets should be included in the investment base.

- To measure economic performance all assets, and possibly an allocation of some corporate assets, should be included.

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Problems with accounting based measures

- Both ROI and RI can lead to poor decisions because of depreciation policy. This can lead to low Net Book Values on existing assets and give the appearance of high returns on low book values – which may be a disincentive to investment in newer assets which could have higher NPVs.

- Accounting based measures typically may not in the short term be consistent with NPV signals.

Addressing the dysfunctional consequences of short-term financial performance measures

- Financial performance measures can encourage managers to become short-term oriented and seek to boost short-term profits at the expense of long-term profits.

- Approaches for reducing the short-term orientation:

  # Focus on meeting cash flow (or profit) targets

  # Adopt EVA incorporating many accounting adjustments.

  # Lengthen the measurement period.

  # Do not rely excessively on financial measures and incorporate non-financial measures that measure those factors that are critical to the long-term success of the organization.

  (i.e. adopt a <u>Balanced Scorecard Approach</u>)

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Divisions may, or may not, trade with each other.

When they do, the prices charged are called “transfer prices”.

A transfer price is revenue for the transferring division and a cost to the receiving division

Aims of a transfer pricing policy

Motivate good economic decisions i.e. Goal Congruence

Provide information to help evaluate performance

Protect divisional autonomy

NB Sometimes these criteria may conflict with each other

For Multinational Companies

A further aim is to (legally?) minimise tax

Regulations are typically based on OECD guidelines, which use the principle of "arms-length" pricing.

See, for example, an update of Italian Regulations

Transfer pricing and allegations of aggressive tax avoidance and tax evasion can be a very contentious area.

See, for example, this animation on the website of the Global Alliance for Tax Justice