Workshop Lecture 4

Part of an ACCA question

1. Brace plc is split into two divisions, A and B, each with their own cost and revenue streams. Each of the divisions is managed by a divisional manager who has the power to make all investment decisions within the division. The cost of capital for both divisions is 12%. Historically, investment decisions have been made by calculating the return on investment (ROI) of any opportunities and at present, the return on investment of each division is 16%.

A new manager who has recently been appointed in division A has argued that using residual income (RI) to make investment decisions would result in 'better goal congruence' throughout the company.

Each division is currently considering the following separate investments:

	Project for Division A	Project for Division B
Capital required for investment	\$82·8 million	\$40·6 million
Sales generated by investment	\$44·6 million	\$21·8 million
Net profit margin	28%	33%

Required:

Calculate both the return on investment and residual income of the new investment for each of the two divisions.

Comment on these results, taking into consideration the manager's views about residual income.