Case study – Rewarding divisional performance

This is the solution to the case study found at the end of:

- Chapter 21 *Performance Measurement and Reporting*

(a)

The big problem facing Khaleb and the Components division is lack of profitability as measured by ROI. Any strategy adopted by the division or by the company as a whole must tackle this fundamental problem. It seems likely that ROI for the division will improve to some extent because of the improvements to the fixed asset base that were made by Lara. However, the division is a very long way from achieving the level of ROI targeted by the company. Specific problems that cannot be addressed at divisional level include the following:

1. There appears to be a significant transfer pricing problem. The contribution margin of products sold to other divisions is far smaller than that achievable on sales to outsiders. The component cost to Chem and Pharma divisions is highly advantageous, and produces significant cost savings for them. Although it is possible to tackle transfer pricing problems by negotiation between divisions, this option may not be open to Khaleb. He is new to the business, and probably lacks bargaining power. His fellow divisional heads will be very reluctant to accept higher transfer prices, in part at least because of the adverse effect it will have on their own bonuses. Renegotiation of transfer prices on a significant scale will probably require intervention at a senior level. Khaleb needs to begin the process of lobbying head office management to review the position.

2. The ROIs of the three divisions may not be strictly comparable. Components has acquired a lot of new fixed assets recently, and its asset base may be relatively higher than that of the other two divisions. The improvements that might be expected to the return part of the equation (because better fixed assets should produce better returns) may not have fully emerged yet, and in any case, we know from the case that fixed asset capacity is not fully utilised. It is important when comparing ROI that like is compared with like.
3. The company appears to take a very simplistic approach to performance appraisal, relying wholly on ROI. The assessment of performance probably needs to be managed in a more subtle way, but any changes to performance assessment need to be determined at head office level. Khaleb may be able to exert some influence in any debate on the best way to assess performance but, as a divisional manager, he has no power to insist on any revision to the company's appraisal systems.
4. The problems inherent in the use of the ROI measurement have particular impact in the context of SCI because of the key role played by ROI in the awarding and calculation of bonuses. It is rarely a good idea to award performance related bonuses on the basis of a single measure of performance. Even if Khaleb manages his division spectacularly well, Components' ROI is so far away from target that he does not stand to benefit personally. Lara, his predecessor was clearly not well regarded in the company, but this assessment of her may prove to have been unfair. The fixed asset replacement programme that she instituted was a step in the right direction, but it would not have paid off for her personally for a very long time, if ever. Khaleb may find that he grows discouraged because the odds are stacked against his division.

5. Sales volumes, it appears, are not as high as they could be. Extra productive capacity is available if additional sales volumes can be achieved, but there is a problem in that sales staff are not well-motivated and, in any case, tend to lack experience. It may be that Khaleb can tackle this problem, at least in part, at divisional level, if he has the authority to alter the basis of employment contracts. If he can improve sales' staff remuneration and incentives, the division could probably perform much better. However, if conditions of employment are uniform throughout the company (i.e. if they are under senior management control), the problem can be addressed only at head office level.
6. The bonus system is very limited in its application. There may be benefits to be gained across the company by extending performance-related bonuses to senior divisional managers such as Ester.

(b)

SCI's senior management probably needs to undertake a fundamental review of the company's operations, and of its performance review and incentive systems. This could involve the following steps:

7. Immediate review of transfer pricing arrangements to ensure that they are equitable to all of the divisions. Khaled's division appears to be at a significant disadvantage.
8. Review of the whole performance review system. The reliance on a single measure (ROI) is potentially very damaging to the interests of the company as a whole. Performance measurement should be more complex, and should ideally involve consideration of a range of both financial and non-financial indicators. The company could consider implementing a Balanced Scorecard

system. In order to do this properly, a full re-appraisal of business strategy would probably be in order, and this might be of great help in challenging increased competition.

9. It may be appropriate to agree a set of specific targets for Khaled's division that are geared to improving its current position, and to rewarding the staff accordingly. Where the position of the divisions is unequal, as in this case, staff in the struggling division can easily become demotivated. Targets need to be set with a view to encouraging and rewarding improvements in performance.

10. The performance bonus system could probably be extended to a greater number of senior managers in the divisions to encourage better performance. Also, if employment contracts are under central control, senior managers need to reconsider the incentives that they provide.