Chapter 10 Questions

1. The operations of **Warkworth Sunter** are split into profit centres, all of which are required to report monthly. The basic performance criterion is that all profit centres should earn controllable profits amounting to at least 44% of sales. In BC profit centre, the accountant has extracted the following figures from the records for March 2010:

	€
Sales	65,033
Depreciation of fixed assets	6,444
Administration costs (90% fixed)	13,340
Direct materials cost	9,804
Direct labour cost	12,750

The administration costs are all controllable by the profit centre. Depreciation is not controllable at divisional level. Head office costs of €8,883 should also be taken into account for the month.

Required: from the information given, prepare a divisional performance statement for the profit centre BC. Does BC meet the head office basic performance criterion in March 2010?

2. Salamander Products manufactures a range of industrial furnaces and ovens. The directors are discussing a plan to expand the company's operations into related areas, together with an internal reorganisation to decentralise their existing activities. Georgette, the Operations Director, explains the advantages of the scheme:

"Over the next three or four years, if we follow a strategy of acquiring other businesses, we are all going to be very busy identifying investment opportunities. This company has a lot of middle management talent, and I think that the company as a whole will undoubtedly benefit from letting these people have more responsibility. If we appoint our best managers to head up the separate divisions, and give them a profit related pay incentive, they'll be motivated to produce even better results than they do at the moment".

Required: identify and briefly discuss two weak points that are apparent in Georgette's arguments for splitting the company's activities into divisions.

3. Identify each of the following statements as TRUE or FALSE

a) Return on investment is a useful performance measure for head office management to help them identify weaknesses in cost centre management
b) Return on investment is calculated by dividing controllable profit by investment in net assets
c) The use of return on investment as a performance measurement can have adverse consequences for the company as a whole
d) Return on investment is calculated by dividing divisional net profit by investment in net assets

Chapter 10 Answers

1. Warkworth Sunter

Divisional performance statement for BC for March 2010

	€
Sales	65,033
Less: variable costs (9 804 + 12 750 + [13 340 x 10%]	(23,888)
Contribution	41,145
Less: Controllable fixed costs (13 340 x 90%)	(12,006)
Controllable profit	29,139
Less: Non-controllable fixed costs (depreciation)	(6,444)
Divisional profit before allocation of head office costs	22,695
Head office cost allocation	(8,883)
Divisional profit before tax	13,812

Controllable profit as a percentage of sales:

$\frac{29,139}{65,033} \times 100 = 44.8\%$

So, BC does meet (just) head office's performance criterion.

2. Salamander Products

One of the arguments for divisionalization is that it tends, in favourable conditions, to increase managerial motivation and competitiveness. However, beyond a certain point, high levels of managerial motivation at divisional level can produce results that are dysfunctional for the company's interests as a whole. If divisional managers take a very short-term and narrow view, they may undertake activities (such as aggressive transfer price setting) that are damaging to the profitability of the business. Therefore, Georgette may be somewhat misguided in her opinion that divisionalization will benefit the company as a whole.

A related point is that profit related pay, while it certainly is an incentive, may not always be in the company's best interests. For one thing, if managers are set high targets for performance measures such as ROI, they may be motivated to misstate their division's results in order to meet the targets. Also, they may be tempted to indulge in short-termist behaviour, with the goal of meeting targets, which is not ultimately in the best interests of the company.

3. Statement 1 is FALSE – return on investment is not an appropriate performance measure for a cost centre (because cost centre managers have no control over investment).

Statement 2 is FALSE

Statement 3 is TRUE

Statement 4 is TRUE