Divisional Performance Measurement

Performance measurement is the performance-based management process which is flowing from the organizational mission and the strategic planning process. Divisional performance measurement includes the objective and subjective assessments of the performance sub-units of an organization such as divisions or departments. Divisional performance measurement are effective in ensure that a strategy of organisation is successfully implemented by monitor a divisions effectiveness in satisfying its own predetermined goals or stakeholder desires. Divisional performance measures may be based on non-financial as well as on financial information.

Divisional Performance Measurement – Financial Measures

1. The Return on Investment (ROI)

Nowadays, most of companies concentrate on the return on investment (ROI) of a division that is profit as a percentage in direct relation to investment of division which instead of focusing on the size of a division's profits. ROI addressed divisional profit as a percentage of the assets employed in the division. Assets employed can be defined as total divisional assets, assets controllable by the divisional manager, or net assets.

The main advantage of using ROI is provides a valuable information about the overall approximation on the success of a firm's past investment policy by providing a abstract of the ex post return on capital invested. According to Kaplan and Atkinson, they state that however, lack of some form of measurement of the ex post returns on capital, there is still useful for accurate estimates of future cash flows during the capital budgeting process. When ROI is used as a managerial performance measure, Measuring returns on invested capital also focuses managers' attention on the impact of levels of working capital (in particular, stocks and debtors) on the ROI. It can lead to decisions making that are optimal for individual divisions but sub-optimal for the company. ROI focuses on short-term profitability, looking only at the last quarter or last year for performance evaluation. This time horizon may not be long enough for many projects to be evaluated.

A further attraction of ROI is that it can compare the return of different businesses field for example division within the company or competitors by adopting it as a common denominator. Therefore, corporate managers want their divisional managers to focus on ROI so that their performance measure is congruent with outsiders' measure of the company's overall economic performance. However, the used of ROI for evaluating the economic performance of a division is more appropriate than evaluating the managerial performance, since controllable profit and assets are not exposed in external published financial statements. For comparing the economic performance of a division, net income is likely to be the preferred profit measure to be used as the numerator to compute ROI in order to ensure consistency with the measures that are derived from the financial reports of similar companies outside of the group. ROI has been most widely used financial measure for many years in all types of companies.

ROI is also a useful medium to communicate the ROI to those who have varying degrees of financial knowledge. The ROI concept allows managers to speak the same language when handle project goals in financial terms across several departments in a corporation as well Information Technology (IT) vendors use ROI as a sales tool to easily convey the economic value of their products.

2. The Residual Income (RI)

Residual income overcomes the dysfunctional aspect of ROI. It is because the use of ROI as a performance measurement can lead to under-investment. For example a manager currently achieving a high rate of return (say 30 percent) may not wish to pursue a project yielding a lower rate of return (say 20 percent) even thought such as a project may be desirable to a company which can raise capital at an even lower rate (say 15 percent). Thus, used RI is better than ROI.

The purpose of evaluating the performance of divisional managers, RI is defined as controllable contribution less a cost of capital charge on the investment controllable by the divisional manager. For evaluating the economic performance of the division RI can be defined as divisional contribution less a cost of capital charge on the total investment in assets employed by the division.

Besides, RI is favour than ROI and it more flexible because different cost of capital percentage rates can be applied to investments that have different levels of risk. There is not only will the cost of capital of divisions that have different levels of risk differ so may the risk and cost of capital of assets within the same division. The RI measure enables to calculate the different risk-adjusted in capital cost while ROI cannot incorporate these differences.

3. The Economic Value Added (EVA)

ROI and RI cannot stand alone as a financial measure of divisional performance. One of the factors contribute to a company's long-run objectives is short-run profit ability. ROI and RI are short-run concepts that deal only with the current reporting period whereas managerial performance measures should focus on future results that can be expected because of present actions.

RI has been refined and re-named as economic value added (EVA) by the Stern Stewart & Co. EVA is a financial performance measure based on operating income after taxes, the investment in assets required to generate that income and the cost of the investment in assets (or, weighted average cost of capital). The objective of EVA is to develop a performance measure that find the ways in which company value can be added or lost. The EVA concept extends the traditional residual income measure by incorporating adjustments to the divisional financial performance measure for distortions introduced by GAAP. Thus, by linking divisional performance to EVA, managers are motivated to focus on increasing shareholder value.

The objective of developed EVA is producing an overall financial measure that encourages senior managers to focus on the delivery of shareholder value. According to Stern Stewart & Co. the aim of companies' managers whose shares are traded in the stock market should be to maximize shareholder value. Therefore, financial measurement is an important key used to measure divisional or company performance should be congruent with shareholder value. They claim that compared with other financial measures, EVA is more likely to meet this requirement and also to reduce dysfunctional behaviour.

EVA is not just a performance measure but can be the major part of an integrated financial management system leading to decentralized decision making. It leads the each different department managers to make the best decision lies to the company's goals. Thus adoption of EVA should indirectly bring changes in management which in turn can enhance company value.

The apparent success of EVA is that many companies had derived from using EVA to motivate and evaluate corporate and divisional managers. In fact, companies which have adopted EVA as the basis of management performance measurement have experienced a significant increase in their shareholders' wealth.

Limitations of Financial Performance Measures

Financial performance measures are generally based on short-term measurement periods and this can encourage managers to become short-term oriented. For example, relying on short-term measurement periods may encourage managers to reject positive NPV investments that have an initial adverse impact on the divisional performance measure but have high payoffs in later periods.

Financial performance measures are as lagging indicators by time lag between actions and results. They state the outcomes of management's actions after a period of time, produce too late to influence current decisions. Therefore, it's hard to understand or know what the manager did caused what to happen. Hard to know, what the manager did that makes the thing going well or bad as well.

Financial performance measures are limited to current reporting period only and it needs to be supplemented by non financial information such as customer satisfaction and quality while Managerial performance measures focus and expect what will be the future result.

The major problem is obtaining profit measures are based on the historical cost concept and thus tend to be poor estimates of economic performance. Companies tend to rely on financial accounting-based information for internal performance measurement. This information may be appropriate for external reporting but it is doubtful for internal performance measurement and evaluation. In particular, using GAAP requires that discretionary expenses are treated as period costs, resulting in managers having to bear the full cost in the period in which they are incurred.

Many traditional measurement and evaluation methods such as ROI, EVA, ROCE and so on have failed to yield an appropriate estimate of the 'pay back' from these complex systems. Some claim these performance indicators have a high reliance on financial perspectives and thus portrait only one facet of the organisation.

Divisional Performance Measurement – Non-Financial Measures

1. Balanced Scorecard (BSC)

Balanced Scorecard was introduced by Kaplan and Norton to overcome the shortcomings of traditional management accounting and control which fails to signal changes in the company's economic value as an organization makes substantial investments or depletes past investments in intangible assets. The scorecard contains four different perspective which is financial performance, customers, internal business processes, and learning and growth. These perspectives reflect the interests of the key stakeholders of companies involving shareholders, customers and employees.

There are several benefits of adoption the balanced scorecard highlight by Kaplan and Norton. One of the benefits is focusing the entire company on the few key things needed to create breakthrough performance. A balanced scorecard might show that an organisation is only weak in a couple of areas but that these areas are impeding its overall success. By focusing everyone in the organisation on improving those areas, overall performance gets better.

Next, it assists to integrate different company activities such as quality and customer service. By looking at different organisational programmes or units from different perspectives can be a way of getting everyone singing from the same song sheet. If the balanced scorecard shows customer service to be weak, focusing on everybody's customer service performance behaviours will lead to small improvements in each department or unit; the overall effect will be a bigger improvement in the organisation's customer service performance across the board.

Lastly, managers and employees both know what is required to achieve excellent overall performance by breaking down strategic measures to lower levels of the organisation. For example, an organisation might have overall goals to increase productivity by 5 per cent. By breaking down its productivity measures to granular levels of the organisation as part of a balanced scorecard, every member of the organisation will have clear targets that achieve their overall goals.

2. Performance Prism

The Performance Prism takes a drastically different look at performance measurement and sets out clearly to recognize how managers can use measurement data to improve business performance. It has a much more comprehensive view of different stakeholders for example investors, customers, employees, regulators and suppliers than other frameworks. It must be considering the wants and needs of stakeholders first before the strategies can be formulated. Thus, the stakeholders and their needs have been clearly identified, if not, it is impossible to form a proper strategy for company. Now lots of measurement frameworks for example like the balanced scorecard tends to take a fairly narrow view of stakeholders which refer to shareholders and customers. However, it ignores employees, suppliers, regulators and in today's society organisations can't afford to ignore those different pressure groups. Those different groups of stakeholders that might be interested in the business.

The strength of this conceptual framework is that it first questions the company's existing strategy before the process of selecting measures is started. In this way, the framework ensures that the performance measures have a strong foundation. The performance prism also considers new stakeholders (such as employees, suppliers, alliance partners or intermediaries) who are usually neglected when forming performance measures.

It is structured to throw light on the complexity of an organisation's relationships with its multiple stakeholders within the context of its particular operating environment. It provides an innovative and holistic framework that directs management attention to what is important for long term success and viability and helps organisations to design, build, operate and refresh their performance measurement systems in a way that is relevant to the specific conditions of their operating environment.