

## PERFORMANCE MEASURES

### Essex Engineering

Essex is an industrial company with three divisions. Both the Midland Division and the North Division are long established. Senior managers are concerned that these divisions have a high percentage of products that are near the end of their product life-cycle. Forecast sales increases over the next 5 years is expected to be in the region of 4-5% per annum.

The East Division was acquired in 1999 and senior managers are optimistic that this division has very good growth potential. Most of the senior managers at this division have experience of working at the other divisions.

Since 1999 the head office has ranked all divisions according to return on investment (ROI) and residual income (RI). All managers believe that the rankings are important for future promotions and career development.

A small number of other performance measures are also used by managers. These include

1. Non-productive time: Non-productive direct labour hours (percentage of total hours paid).  
Non-productive time includes time wasted as a result of production delays or material shortages.
2. Customers: Customer complaints (percentage of total number of customers)
3. Lead time: Time from order to delivery

These performance measures were agreed by all managers in 1999. At the time it was thought that managers should focus on only a small number of measures.

**2002:** The managers at the divisions provided the following information for the head office.

#### Selected data from the budgeted Management Accounts to 31 December 2002

|   | Midland<br>Division<br>(£) | Northern<br>Division<br>(£) | East<br>Division<br>(£) |
|---|----------------------------|-----------------------------|-------------------------|
| Sales   | 1,580,000                  | 1,560,000                   | 1,112,000               |
| Cost data   |                            |                             |                         |
| Controllable cost of goods sold                             | 650,000                    | 620,000                     | 380,000                 |
| Non-controllable cost of goods sold                         | 116,000                    | 115,000                     | 100,000                 |
| Controllable Selling general & Administrative overheads     | 370,000                    | 400,000                     | 370,000                 |
| Non-controllable Selling general & Administrative overheads | 250,000                    | 250,000                     | 162,000                 |
| Total costs   | 1,386,000                  | 1,385,000                   | 1,012,000               |
| Capital employed  |                            |                             |                         |
| Total investment  | 1,400,000                  | 1,440,000                   | 850,000                 |
| Controllable investment                                     | 1,200,000                  | 1,111,000                   | 800,000                 |
| Sales growth 2003   | 4.80%                      | 5.20%                       | 28.00%                  |
| Sales growth 2004   | 4.30%                      | 5.10%                       | 37.00%                  |
|   | 1,580,000                  | 1,560,000                   | 1,112,000               |

### Other measures

|   |      | Midland<br>Division | Northern<br>Division | East<br>Division |
|---|------|---------------------|----------------------|------------------|
| Non-productive time: Non-productive direct labour hours (percentage of total hours paid). | 2001 | 4%                  | 4%                   | 6%               |
|   | 2002 | 4.1%                | 3.8%                 | 7.5%             |
| Customer complaints (percentage of total number of customers)                             | 2001 | 1%                  | 1.2%                 | 5%               |
|   | 2002 | 1.1%                | 1.1%                 | 6%               |
| Lead time: Time from order to delivery  | 2001 | 10 days             | 9 days               | 15 days          |
|   | 2002 | 11 days             | 9 days               | 18 days          |

The head office has estimated that the group cost of capital is 10%

### **Ranking divisions in 2000**

In 2000 the data on controllable and non-controllable costs and investments will be used to rank divisions.

### **Requirements:**

#### **Question 1**

Based on the data provided comment on the relative financial performance of the two divisions and **discuss** how the ranking of the divisions changes if controllable and non-controllable costs and capital employed are analysed.

#### **Question 2**

Evaluate the choice of performance measures for the 3 divisions

#### **Question 3**

Identify and evaluate the difficulties faced by managers when measuring capital employed for a division.

#### **Question 4**

Discuss how using ROI can result in managers making poor investment decisions.

#### **Question 5**

Discuss the particular problems multinational companies have when evaluating the performance of divisions.

### **Reference:**

McGraw-Hill Higher Education

[http://highered.mcgraw-hill.com/sites/0077098595/student\\_view0/case\\_studies.html](http://highered.mcgraw-hill.com/sites/0077098595/student_view0/case_studies.html)