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Jelena ĆIRIĆ[1], Slobodan MALINIĆ[2]

MEASURING THE PERFORMANCE OF BUSINESS SEGMENTS AND DIVISIONAL MANAGEMENT

Abstract:
Multidivisional company consists of several divisions or business segments, usually in the form of profit or investment centers. Business segments are not independent legal entities, but have their own revenues, expenditures, financial result, and if it comes to investment centres decisions on the amount of investment are made. Something useful to a business segment or division may not be optimal from the aspect of the company as a whole. Business segments are also competitors. In those business segments managers have information that is not fully available to management at the highest level. Divisional managers, as agents are motivated to achieve better results in business segments that are delegated to them, and compensation schemes and bonuses can be so set that short-term financial interests of the segment dominate in relation to long-term interest of the owner - increasing the company value.

Keywords:
business segments, decentralisation, management, performance

INTRODUCTION

Centralized management of complex business in an uncertain and dynamic environment does not provide conditions for survival and development of a company. The growing instability and complexity of environment and technology, as well as growth and development of the company through diversification requires a certain degree of decentralization of management and flexible organizational structure that will adapt with frequent changes in the environment and the company. Reply of a modern enterprise in a complex and turbulent environment is the complex internal organizational structure that is essential for effective management. By choosing an organizational model company can respond more or less successfully to the action of numerous internal and external factors in the business. Managers of profit and investment centers as decentralized organizational units have the discretion to make decisions, select and implement specific activities. In order to estimate the performance of the managers of these responsibility centers, ways of measuring their performance have to be defined and it is duty of management at the highest level. Top management defines the rules and measures for managers at lower levels, as well as rewards for those managers whose decisions and actions are consistent with the objectives of the company as a whole.

DECENTRALIZED DECISION MAKING AND DIVISIONAL MODEL OF THE COMPANY ORGANIZATION

Through decentralized decision making and delegation responsibilities to lower levels specialised information of managers at local levels can be used. They respond more quickly and flexibly to changing customer demands, *changes in technology, environment and so on. By delegating decision making, top management is released from operational decisions, and their time as a limited resource is used for strategic decisions making. At the same time, managers at the lower level benefit, because they gain authority and responsibility for decision making in order to acquire the necessary training and experience that can be useful to them in the future and can provide them top management positions. In this way motivation, creativity and entrepreneurial spirit of local managers are encouraged and also those who are able to become decision makers at the highest level are selected. In the modern business environment is almost impossible to process local character information to the top management. It would require too much time and other resources and benefits would not be greater than the costs. Generally there is a view that decisions should be made at the level where the relevant information are produced, stored and processed. When the local managers have authority, they can make and realize some decisions without consulting top management and react timely to changes and problems in the life of a company. This prevents the delay in communication and unnecessary waiting for responses from the highest levels.*

The company with decentralized decision making usually apply divisional organizational model where divisions are formed as decentralized organizational units. Divisions do not have legal independence, but have their own revenues, expenditures and results. Division should be profitable in the markets or market segments they serve and should also contribute to profitability and competitive advantage of a whole company. Division as a separate organization unit whose management has special authority and responsibilities in accordance with the objectives they wish to achieve, is known as strategic business unit - SBU. Divisional organizational model requires the definition of the relationship between the divisions and implementation of motivational mechanisms. Divisions are competing with each other, but at the same time try to be profitable and to contribute to corporate profitability. Divisional model is quite flexible due to the short communication lines is more efficient, faster response to the changing demands of consumers with the possibility of direct contact with them. Employees can see their place and role in the division and be motivated through different mechanisms, and top management can control easier performance of a division. The disadvantage of this model is that there can occur a conflict between divisions that are also competing with each other for company's resources, then possible rising costs of joint activities and loss of top management control over the operations of business segments [1]. By implementing decentralized decision making the right measure of delegating authority and responsibility should be find, then actual effects of decentralized units and their management should be assessed and evaluated, and depending on their achievements the incentive mechanisms should be implemented in order to achieve a balance between benefits and costs of decentralization.

THE IMPORTANCE OF THE FORMING OF PROFIT AND INVESTMENT CENTERS AND THEIR CHARACTERISTICS

From the aspect of financial performance, as traditional method of monitoring the success of decentralized organizational units, they can be in the form of cost, revenue, discretionary centers (budgeted) expense, profit and investment centers. Standard cost centers are established when the output is measurable and when the standard prices and standard expenditures are known [2]. Cost center managers are responsible for the efficiency and the effectiveness of its center, ie. for the producing products on time and according to quality standards, which reflects the performance of other organizational units. All other decisions such as production volume, pricing, product mix are made at the level of top management.

Revenue center manager is responsible for sale and distribution of products. If manager has the authority to define the selling price, he is also responsible for the gross income. But if the selling price is defined at the corporate level, revenue center is responsible for sale volume and sale mix. The performance evaluation of revenue center should include some concept of cost, otherwise the center will be interested only to increase revenue, and not to increase marginal profit. Revenue center managers will insist on reducing sales prices in order to increase total sale and spend additional funds to *promote low budget products. Although this is the way to increase the total sale revenue, this reduces the profitability of the company. Centers of discretionary (budgeted) expenditures are formed in the organizational units that do not produce a measurable output expressed in the financial indicators (e.g. department of administration and sales) and in units where there is no stronger relationship between inputs and outputs (e.g. research and development department). Due to the impossibility of measuring the actual results of the center there is a risk of the appearance of information asymmetry.*

Profit center manager has the authority in the field of production and sale. He decides which products, at what price and how to produce, sell and distribute. Manager decides to which products he will allocate resources. He should establish an optimal relationship between scope, cost, quality and product cost. Most profit centers managers do not have authority about the level of investment and realized profit is the main short-term indicator of the performance of profit center and its management. Usually it's made the comparison between realized and budgeted profit. Profit centers are important from the aspect of planning, control and motivation in a decentralized company. Regarding the profit center also consists of the cost and revenue center, the costs and revenues are also planned, which is important to the top management who has to adjust the budgets of many organizational units. The higher the degree of controllable factors, the greater is management responsibility for results. More divisions can create a profit center, but also in one division may exist more profit centers. In order to become a profit center, division should meet the following conditions [3]: 1) to have a critical mass of direct revenue and expenditure, in order to control profit center through the profit, 2) that managers have sufficient authority to take actions that could significantly affect the result, 3) to have their own recognizable external market of inputs and outputs, 4) that the relationship between organizational segments are clearly defined so that profit of each of them is independent of the decision and the efficiency of other profit centers, and 5) that there is readiness of top management to control the success of decentralized units through the realized profit or loss.

Top managers delegate authority to the investment centers managers and on that basis they make decisions on assortment, pricing and the amount and type of investment. In this way, investment centers get characteristics of an entity, but without legal autonomy. An investment center can consists of several profit centers. In order to become an investment center a division should [4]: 1) meet the requirements relating to the establishment of profit centers, 2) organizational segments are recognizable enough and have their investments and costs of capital so that control over the rate of return has meaning, 3) to the managers of these organizational units should be delegated the authority to make decisions that determine profit, but also the type and quality of the investments, 4) the readiness of top management to decentralize decision making and to control responsibility centers and their managers through rates of return and / or residual income.

Although the decentralization process is deepened by forming investment centers, obtaining external funding sources, as well as research and development activities generally remain at the top management level. In order to determine the performance of an investment center, two basic indicators are return on investment - ROI and the residual income or economic value added - EVA. It is no longer enough to use only data from the income statement (as it is case for the profit centers), but also data from the balance sheet, where tha data about amount of assets is used. Managers of profit and investment centers are held accountable to the top management, who had delegated authority to them, unlike top management who is held accountable to the shareholders and other external users of financial statements for the results of the company.

MEASURING THE PERFORMANCE OF BUSINESS SEGMENTS AND DIVISIONAL MANAGEMENT

Performance of a company and its segments can be expressed with financial and non-financial indicators. The most common is a profit because it expresses the total performance of a company and it is a common denominator for objectives of a company and its segments. There are different performance measures in *manufacturing and service companies, in profit and nonprofit organizations and institutions, and measures depending on the key factors of success such as cost, quality, time, innovation, flexibility and others [5].*

Traditionally performance measurement and analysis is based on the financial statements. Company's performance can be expressed by the ratio numbers such as revenue profitability and assets and capital profitability. Revenue profitability ratios are calculated as relation between the different forms of profit and realized revenue. In that way can be determined rate of operating profit, gross profit, contribution, residual or net profit, which shows their relative share in the revenues. Ratios of capital and assets profitability indicate the level of increase of employed assets and capital. It can be counted rate of return on total assets, or only the operating assets, or the rate of return on total capital or only return on own capital. Rates of return are counted as relation between the realized returns in the form of profits and accounting positions by whose engagement is achieved the return on the assets or on the capital.

By measuring profit center performance, results of manager and his responsibility center should be distinguished. Factors that divisional manager cannot control, such as changes in the value of property and equipment of profit center, should not be included in the assessment of his performance, because such decisions are usually made at the highest level. If managers of profit centers or strategic business unit (SBU) have responsibilities about level of investments, then return on investment (ROI) is calculated, when net return before tax is divided to investments.

Regarding capital still has an alternative usage managers should direct capital to those business segments in which the ROI is above the cost of capital. Calculating the ROI is useful from the point of budget the necessary amount of capital in the planning period. Capital is invested in the noncurrent and current assets and through the measuring the ROI an incentive is given to the divisional management to reduce current assets through faster realization of receivables and inventory reduction, or through the acceleration of their turnover.

For evaluating the performance of investment center usually is calculated ROI, but it also has certain disadvantages. In the modern performance measurement systems one of the criteria for awarding divisional management is the level of ROI and thus managers could rejected those projects whose ROI is below average, but above the cost of capital at the level of division. In other words, managers will accept those projects that give higher divisional ROI, but do not increase a long-term value of the division and the company. So it is not enough to calculate a ROI as only success indicator of the of profit and investment center, and as criteria for awarding divisional management. It is necessary to calculate the economic value added - EVA or residual income. Residual income harmonizes the divisional objectives and activities with the decisions that increase the value of the divisions and company. From the point of this indicator eligible projects are those who reject the ROI above the cost of invested capital. This indicator is flexible and varies depending on the rate of risk. EVA or residual income is calculated by subtracting opportunity cost of invested capital from the net business profit after tax. EVA is an estimate the amount above or below the minimum acceptable rate of return for shareholders and creditors. Unlike the market value added, EVA can be counted on divisional level, ie. business unit level. As an economic indicator EVA is based on the idea that the business must cover operating expenses and capital costs.

EVA calculating:

Net sales - Operating Expenses = EBIT - Taxes = NOPAT - Cost of capital (Invested Capital x Cost of capital) = EVA

EBIT - Earning Before Interest and Taxes

NOPAT - Net Operating Profit After Taxes

ROI indicator is calculated for almost ninety years and has been developed for the first time in the company Du Pont, in 1923. Regardless the abovementioned disadvantages, it is a relative measure of the company success and is easy to compare to other relative financial measures - rates, unlike EVA that is an absolute measure of success of the company and its segments.

When incentives are known to the divisional managers, they tend to maximize the defined performance measures of the responsibility centers and those measures are mostly return on investment (ROI) and Economic Value Added (EVA). It is very important to define correctly the rewards and incentives for divisional managers *in order to motivate and evaluate their performance. Often managers are motivated to improve short-term performance of its responsibility center, but at the cost of achieving the objectives of other divisions or whole company. For example, a manager of a revenue center may be primarily interested in increasing revenue, although contribution is more important from the company's aspect. As a result, it's more insisted on monitoring strategic (long term) performance indicators of the company and its segments through strategic tool such the BSC is. If divisional measurement are compared only internally, e.g to the previous period performance or in relation to the planned indicators, one could get an unrealistic picture of the division performance. If the conjuncture impact positively on all companies in the branch, the majority of companies and their decentralized units will achieve better performance than expected or the past. Therefore, it is always advisable to consider effects of external factors, such as whether the market share or profitability of the observed division have changed. For this purpose top management need information of divisional management. Another problem in measuring performance arises because most of the performance measures are short-term. Motivated to achieve better and easily measurable results in the current period, on which they get bonuses and rewards, divisional managers avoid investments in intangible assets - research and development, human resources, quality improvement. The effects of these investments are not objectively measurable, appear in the future, and in the current period reduce rate of return, which is the base for evaluation of manager performance. Also the effects of investments in intangible assets manifest later in the period when manager who decided about investment would be on some other managerial position in the same or even in another company. Regardless the great importance of these investments to the long-term value of company, such as increasing product quality, improving employee morale, better services, are hard to measure, visible only in the long term and differ from traditional financial indicators of performance. That is the reason why periodic profit reporting dominates and in order to improve short-term results long-term profitability is sacrificed. The solution may be to define the target values that managers need to achieve in the field of human resources, quality products and services, distribution and other areas or to implement BSC at the divisional and corporate level.*

In complex companies there are some decentralized organizational units (divisions) that exchange effects, at prices that are called transfer. Transfer prices depend on whether market-based, cost-based or negotiated model of transfer pricing is applied [6]. From the transfer prices depends income or selling division i.e the cost of purchasing division, which is further reflected on the performance of divisions and their management. Because of that transfer pricing are often a source of conflicts and managers are very interested in the way of determining transfer prices. Whenever it's possible, advantage in the purchasing should be given to the transfers of intermediate products between divisions. But if the transfer prices are set too high divisional managers will prefer an external purchase, which will increase the benefit of purchasing division, but not the benefit the company as a whole. Except the price, in the transfer of intermediate products, the quality and timely delivery are also important. Transfer prices have dual, mostly conflict role. On one side they are essential for business decisions and they inform production manager how much to produce and to sale manager how much to order. On the other hand, they help to the top management company to evaluate performance of profit centers. The problem arises when divisional managers make decisions that misuse the performance measurement of their responsibility center. Guided by the desire to maximize short-term divisional profit, managers take actions that cause falling of corporate profit. Transfer pricing leads to conflict between, on one side the business decision making, and on the other side between divisional performance measurement and their management [7]. Dysfunctional behavior of managers during the negotiations about transfer pricing means that they favor the maximization of short-term performance at the expense of long-term corporate profitability.

By implementing the Balanced Scorecard (BSC) concept the company gets a performance measurement system which identifies factors that enhance long-term financial performance *through four interconnected perspectives - financial, learning and growth, customers and internal process perspective. It is based on 15 to 20 different measures that are implemented. The high morale of employees improves internal processes, increase customer satisfaction and improve financial performance of the company. This is the way how to achieve short-term financial goals and at the same time through the successful realization of the other three BSC perspectives, long term strategy is implemented and the value of the company is increased. Regarding most companies are multidivisional and consists of more divisions or decentralized units, each of them can create own BSC, but also contribute to the realization of the corporate strategy.*

CONCLUSION

In the company as a complex organization exist many interest groups that attempt to achieve their own goals, even if it does not contribute to optimization of company's goals and interests. As a result, top management faces the problem how to encourage local management to achieve corporate goals through realization of individual interests. At the same time due to opposite interests arise conflicts and top management should be involved in eliminating potential conflicts. Regardless of the difficulties in choosing the best way to measure divisional management performance, it is necessary to assess and evaluate their contribution to the success of their responsibilities centers and company as a whole. Different incentives mechanisms reduce cost of acquiring and processing information, in order to eliminate dysfunctional behavior of divisional managers and to harmonize divisional and corporate goals. Most managers is primarily focused on maximizing short term profits of which depends on the height of their awards. It reflects negatively on the long-term performance of the company. Therefore, the company management assess performance of divisional management and their responsibility centers not only on the basis of financial indicators, such as mostly ROI and EVA are, but also on the basis of non-financial indicators. Through implementation of the Balanced Scorecard concept (BSC) are included financial and non-financial performance indicators of the company and its segments.

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AUTHORS & AFFILIATION

JELENA ĆIRIĆ[1],
SLOBODAN MALINIĆ[2]

[1] FACULTY OF TECHNICAL SCIENCES, NOVI SAD, SERBIA
[2] FACULTY OF ECONOMICS, KRAGUJEVAC, SERBIA

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