LECTURE 11.5

DIVISIONAL PERFORMANCE EVALUATION

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Recall that firms can be structured in various ways: U form, M form and Matrix form. The organisational structure of the firm determines:

- allocation of decision rights and job descriptions
- performance evaluation protocols
- compensation schemes

We will consider performance evaluations for different organisation structures

1. cost centres
2. expense centres
3. revenue centres
4. profit centres
5. investment centres

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1. Cost centres:

- assigned the decision right to choose the mix of inputs to produce a stipulated output

Possible objectives to measure performance

- costs: minimise costs for a given output
- output: maximise output for a given budget

Challenges

- output of each cost centre must be measurable
- quality must be measurable
- central management must have knowledge needed to specify goals
- minimisation of average costs may not equate to value maximisation

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2. Expense centres:

- assigned the decision right to maximise output (often a service) with a fixed budget
- (relative to cost centres), output tends to be measured subjectively

Challenges

- output is usually subjective and difficult to measure
- if the goal of an expense centre is to maximise output, it's services are often over used
- e.g. human resources, IT
- managers may derive benefits from increasing the size of the center – 'empire building'

DIVISIONAL PERFORMANCE EVALUATION

3. Revenue centres:

- decision rights over how to maximise revenue with a given budget

Possible objectives to measure performance

- maximise revenue for a given price and budget

Challenges

- revenue centres consider revenues but not production costs, so they may not maximise value

DIVISIONAL PERFORMANCE EVALUATION

4. Profit centres:

- decision rights over input mix, product mix, prices (or output) to maximise profits with a fixed budget
- useful when knowledge of production and sales is specific to the division and costly to transfer

Evaluation

- profits relative to a budgeted profit for the division

Key issues

- how to price transfers of goods and services between divisions – ‘transfer pricing’
- externalities between divisions

DIVISIONAL PERFORMANCE EVALUATION

5. Investment centres:

- decision rights over capital expenditures
- often comprise several profit centres

Evaluation

- return on assets: ratio of net accounting income to total assets used by the investment centre

Issues

- evaluation is based on accounting profit, not economic profit
- assets are often measured at cost rather than market value