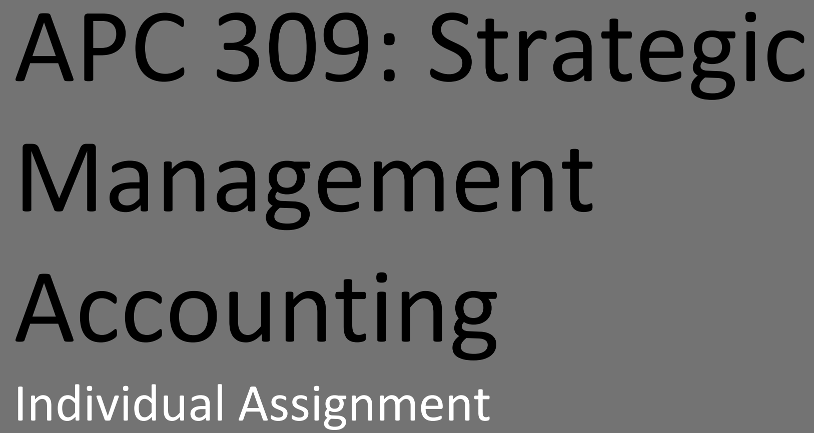

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Part A

"Both Return on Investment (ROI) and Economic Value Added (EVA), when used as performance measures in an organization, encourage managers to be short-term in their focus and decision making."

Introduction

The ultimateobjective of any business entity is to maximize shareholder wealth. But with the separation of ownership, management tends to increase their benefit at the expense of investors. To reduce this matter organizations have linked business value creation to the remuneration of management through performance measures so that whole organization will move towards same direction, creating a win-win situation for each party.

ROI and EVA as performance measures

What is ROI?

Return on Investment (ROI) is a relative measure of organizations' financial performance. It is widely used accepted and can be broken down into secondary ratios for more detailed analysis.

$$\textbf{Return on investment (\%)} = \frac{\text{Net profit}}{\text{Investment}}$$

Though it is a universal measure it has a variety of slightly different definitions and meanings according to how it is to be used. For example, Return on Capital Employed (ROCE), Return on Net Assets (RONA) are also names given to very similar measures of profit over assets.

Certain criticisms over ROI states that it being a relative measure, not considering about the size of investment versus the percentage return divert management focus from potentially attractive investment.(Kaplan,Atkinson,2000)It is phenomenon that high returns come with high risks. Thus some shareholders may prefer high return on smaller amount because this gives them the freedom to invest the remainder in the next best alternative. But managers may select adequate returns on larger scale investments as it'll secure his job with the growth of the firm.

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Sometimes manager who is in charge of a strategic unit may has no control over some committed costs which are irrelevant in assessing their performance. But unfortunately it is difficult to assess the performance fairly concerning on only the facts that are relevant for his performance.

Top management wish to have an attractive figure as ROI as it is a popular indicator used by financial analysts to measure business performance. Thus organizations focus more on maintaining a better number as ROI to create a pleasant perception of the business through the use of ROI.(Sharman, Paul, 2003)

As it is yet another accounting measure, it is highly vulnerable for manipulations. Managers may do window dressing so that they could make the figure look as good as possible through the use of different accounting policies.

Newly acquired assets will lower the ROI. And when performance is compared with previous years with the deterioration of asset value will improve the figure without any effort. Thus managers may reject high valued important asset purchases and may choose less quality products for lesser price also they will certainly think carefully before purchasing them towards the end of the financial year and will probably be postponed.

Even managers may contemplate on asset disposal as its inclusion in investment base may lowersdivision's ROI. Any asset or project whose return is below the average ROI will be a candidate for disposal or will not be recommended for funding. Even though such asset provides a return higher than the company's cost of capital they may precede with the decision of disposal only to earn short term advantages.(Simons, Robert, 1990)

A business firm has to go on investing in order to earn positive cash flows in the future. This will reduce firms' current profitability while ensuring the growth in future earnings. But what level of ROI will assure such long term growth is a question to be focused. It cannot be pre determined and based on the industry it defers. So this is a problem which ROI is unable to solve.

What is EVA?

It is often argued that what is required is an 'absolute' measure of performance expressed in monetary terms. Thus this will encourage managers to take up any project with increasing earnings as this assures that the cost of capital of the project is recovered. It is more flexible

as it can be tested for different levels of risks by imputing different interest rates, therefore maximizing EVA will leads to maximization of shareholder wealth.(Sharman, Paul, 2003)

$$\text{Economic Value Added} = \text{NOPAT} - (\text{WACC} \times \text{Capital Employed})$$

EVA® requires some special adjustments which create confusions and make it difficult to understand when compared with ROI. Adjustments are required to be made to the accounts and certainadjustments are arbitrary. Also the EVA is affected by the size of the firm, and does not consider the relative size of the investment as well. Therefore it becomes impossible for further comparison. Also the estimation of WACC is also subjective for each case as there are many concerns over the cost of capital calculation.(Kaplan, Atkinson, 2000)

As cited by Brewer, Chandra & Hock (1999) in their work,"EVA may focus on immediate results which diminish innovation". (Simons, Robert, 1990)They further states that EVA provides information that is obvious but offers no solutions in much the same way as historical financial statement do. Thus EVA also becomes yet another tool of selecting potentially attractive projects/assets. (Sharman, Paul, 2003)

EVA is less convenient though it is flexible. It being an absolute measure and not being size adjusted is one of the main criticisms over which EVA is being rejected by many firms. This fact itself drives away the management from their focus of creating shareholder wealth. It provides less guidance for accepting projects that aid for the goal achievement of organization. For an instance, there may be investments that are not generating shareholder value but critical when considering organization's social responsibility aspects or for customer satisfaction. Thus ignoring such investments may endanger the firm's goodwill and profitability in the long run.

Short term nature of performance measures

Though these indicators are developed with the focus of removing conflicts over agency relationship, still it has not brought the managers on to the right track as managers are focusing on their own benefits that could be earned in the short run at the expense of the probable firm's growth in long run.

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Most of the limitations we discussed earlier in relation to EVA and ROI are common to many financial performance measures. Managers through unethical means tend to manipulate these indicators in order to increase current benefits. Also it being evaluated and benefits being realized on the same short time horizon is also another major fact that leads to short-termism. But it should be noted that such work will not safeguards its future benefits. Thus managers must thoroughly focus on business continuity.

How the short term nature of such measures can be overcome?

As we all know both of the above measures are yet some of other accounting measures, we know that they are not the perfect tools to measure performance. Therefore many suggest that such financial indicators should not be used as the single summary performance measure.

ROI focuses on firm's profitability and investment it could be measured separately and summed up into a single measure for convenience.(Kaplan, Atkinson, 2000)

$$\text{ROI} = \text{Profitability} \times \text{Investment}$$

$$= \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Asset}}$$

As now it has a profitability measure and asset turnover aspect which assures that the increased profits are not created through reduced turnover, now ROI is more equipped with information and it is more meaningful.ROI could be further analyzed through a Du-Pont analysis so that it could be looked at in a broader perspective.(Simons, Robert, 1990)

Firm may use wider time horizon when evaluating performance so that the rewards will be offered only at the realization of benefits of chosen business opportunities. This will improve the accountability of decision making of managers, creating greater business performance.

Also in order to promote long term visioning measures such as EVA and ROI could be used along with other non financial performance measures. This will reduce the risk of taking up short term incentives at the expense of long term benefits to the organization. Balance Score Card is one such multiple performance measure which looks at managers' competencies in a wider angle, looking at the performance in a bird's eye view. (Horngren, Datar, 2005)Other than focusing on financial performance, measuring steps taken towards customer satisfaction, internal business and for learning and growth perspective of the organization will provide a more comprehensive picture of performance by considering a wider range of responsibilities. Thus this will automatically move them towards long term organizational goals which will

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ultimately lead organization to achieve its vision. Such overall indicator of managers' performance measurement will wipe away the sub-optimization problem as well.

Rewarding performance with option schemes will be another good method of eliminating short sighting in decision making. As managers will now enjoy the benefits of ownership in the future they may take more responsibility of their business decisions. They will choose options that will benefit firm in the long run and create value for firm, by looking at them in a shareholders' point of view.

PartB

Many organisations use transfer pricing when transferring products between different divisions of the same organisation. What are the advantages and disadvantages of those methods?

Introduction

As organizations become large in size and spread across the world, decentralization of decision making and responsibilities become a must for better performance of an organization

With the concern to reduce the cost and grab better business / investment opportunities organizations tend to distribute its functions to several divisions where they operate with autonomy but linked as a network for better performance. On the process, they serve each other as well.

This is where transfer prices come in to play, which are known to be the internally agreed upon prices with which a selling division transfers goods or services to a buying division.

Market based transfer price

One of the main objectives of setting a transfer price mechanism is to make sure that profits of one division should not dependent on the actions of another. Thus to make the price as fair as possible, divisions tend to set price equal the price determined by the market forces (demand and supply theory) or the price of a comparable product/service in the market.
Setting such price will drive the motivation of divisional employees as it allows them to sell/buy in same price in open market, thus will assure that they do not incur any loss through the transaction. Selling division has the same income as in external sales while buying division will find convenience of working with their people at a fair price.

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Also there will be no conflicts over transfer quantities as price will drive them towards equity where ideal quantities will be transferred which will achieve profits and overall company's objective.(Kaplan, Atkinson, 2000)

In certain instances it is difficult to determine the market price because an exact counterpart product is not available in the market. It may be because it is a specialized component or material of a specific product.

Also there may be instances where current market price is highly fluctuating or temporary due to trading conditions so that it is not a representation of the long run price.

To attract new customers some suppliers will quote different initial prices. When outsiders quote lesser price buying division may shift to them to earn profits in the short term without concerning about firm's ultimate objective. This short-termism will create expenses such that the quality of the final product will be deteriorated due to the use of less quality cheap products. (Simons, Robert, 1990)

Depending on the order size, loyalty, buyer's status they may ask for different discounts and credit terms. Thus firms may not charge a uniform price for all buyers.

The major criticism over market price is that firm can earn savings over sales and marketing, packaging, transportation etc. compared to external transfers. Thus market price is an unfair price for buying division in internal transfers.

It should be noted that in some situations the selling division may have to charge a higher price comparative to the market due to the specialized nature of components. It is costly to keep an undisclosed production process than a normal product. So market price is not fair for the selling division at such instances. (Horngren, Datar, 2005)

However if there is a highly competitive marketfor the product it is advisable to use external market price as the transfer price.

Full cost transfer price

When external market price does not reflect the correct price or viewed as an unfair price, a firm can use cost based transfer price.

When using cost basis the actual cost of production cannot be captured to a single unit price easily. Thus a standard cost will be used as the transfer price. Also it should be noted that the cost captured as price will be correct at one output level only. Thus when the division produce varied amount of goods it will not cover the actual cost of production.

But when cost based transfer price is used it is likely to be treated as an input variable cost by the receiving department and if selling prices are based on costs the selling prices may not produce the best results for the firm as a whole as it'll be low priced in the market.

With a full cost based transfer price divisional performance appraisal become meaningless as it will result in a breakeven point or even a loss. So transacting just at a cost will make the employees demotivated. (Sharman, Paul, 2003)Use of cost basis will turn the strategic business unit to a cost center.

In situations where actual costs include inefficiencies of the division, the transfer price set on the basis of such inefficiencies may lead to incorrect management decisions on pricing and using full cost as price will not encourage management to control such inefficiencies.

Cost-plus a mark-up transfer price

The word cost is a wage definition. It may be marginal cost, standard cost, absorption costor even opportunity cost. Whatever it be management should make sure that the added mark up is sufficient to cover all costs and to cover up any variations in estimations so that it will allow the selling division to earn a reasonable profit, allowing employees to be motivated on appraisal results. This price will often be an approximate market price.(Kaplan, Atkinson, 2000)But conflicts may arise between the two sets of managers in terms of setting a price with a fair mark up. At some operation levels where each divisionis trying to be profitable, the company may not achieve its best. Thus the mark up should be selected carefully so that it assures goal congruence.(Simons, Robert, 1990)

Negotiated transfer prices.

Lacking a perfectly competitive market and being aware of the limitations of cost based pricing rules, perhaps the most practical method for establishing a transfer price is through negotiations between the managers of two divisions.Divisions having autonomy, top management support, updated information on market prices and an option of an external market will provide a strong basis for effective negotiations. Negotiations must facilitateto arrive at a fair transfer price that will be advantageous to both divisions and to the organization as a whole. (Simons, Robert, 1990)

Such negotiations may promote team work as now divisions are working in collaboration to find a better solution and will generate creative means that better the whole company.

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Usually negotiations may get extended and are time consuming as it is really difficult to arrive at a price that satisfies both parties. Thus it will lead to conflicts between divisions, creating an unhealthy adversarial climate in which fierce competition can lead to sub optimization. This creates a potential for exerting top management leadership to promote the former situation and will require the time of top management to oversee the negotiation process and to mediate disputes.(Sharman, Paul, 2003) This intervention will even reduce divisional autonomy which is one of the primary objectives of setting up a transfer pricing system.

The experienced manager having good negotiation skills will have an upper hand at negotiations, resulting the measurement of divisional profitability be highly sensitive to the skills of the manager.They may even tend to follow unethical means in order to improve their performances.

The negotiated price may not be the optimum transfer price.It may lead to suboptimal level of output if the negotiated price is above the opportunity cost of supplying the transferred goods.

Conclusion

When deciding what the best method of transfer pricing is subjective upon the business case. However the least acceptable price will be the incremental cost of production where as the highest will be the lowest available market price. So any price within these boundaries is acceptable and selection of such will be based on the focus of the responsibility centres.

Thus managers of each division must work towards making proper business decisions that could improve divisional performance which will ultimately contribute to overall company performance, and at the end will ensure goal congruence which is a primary objective of setting a transfer pricing mechanism.

Setting separate divisions with autonomy and motivating them towards achieving effectiveness and efficiency are some set objectives in order to facilitate a “practical transfer price” which has the credibility of using as a performance measure as well.

Managerial economics will provide insight to this tiring,time consuming and costly exercise which will be beneficial for improved business performance.

Rational for the extensive use of transfer price by modern day firms is to facilitate performance appraisal, as a cost controlling mechanism and to set up a control and accountability system. And organizations must consider that the transfer price set is not

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misleading the shareholder about the financial health of the firm, to escape from tax liabilities or for profit repatriation by multinational firms. Ethical and moral behaviour is highly appreciated by the modern day investors.

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