Context

Bonavista International has its head office in Brisbane, and operates throughout Australia, New Zealand, and parts of Asia. There are three main divisions:

* Brewing Division: this is the oldest division, and it operates major breweries in Perth and Brisbane.
* Newspaper Division: owns leading tabloid newspapers in several cities.
* Cable Television Division: operates cable television services in Asia and Australia. This is a high-risk, growing market.

Each division is headed by a managing director who has been given a high level of decision-making authority. Each managing director effectively runs his or her division as a stand-alone business within the general policy guidelines provided by the board of directors in the head office. Each managing director agrees to achieve a series of targets: return on investment (ROI), market share and sales growth. These targets are developed each year as part of the annual budget-setting process. Intense lobbying takes place between each managing director and the board of directors to determine the most suitable targets.

Each managing director receives an annual cash bonus based on achieving the target divisional ROI. The company defines ROI as operating profit, before interest and taxes, divided by divisional assets (measured at original cost less accumulated depreciation). Senior managers are each eligible for a cash bonus of $74,000 if they reach their divisional ROI target. If performance is above target, share options are awarded at the rate of 24,000 shares for every additional point over target. Thus, if the ROI target is 13 per cent and the division achieves 15 per cent, the manager would be awarded 48,000 share options.

These options are at the prevailing market price on the last day of the financial year and must be taken up within two years of the award. During the past year, the market price of the company’s shares increased from $4 to $6. If the ROI target is not reached, there are no bonuses or share options, and the managing director has to provide convincing reasons for the poor performance. As a consequence of the performance measurement and reward system, the managing directors are highly motivated to achieve, and exceed their ROI targets.

Karl Sharp, the managing director of the Brewing Division, is concerned that his market share, and hence his ROI, is likely to suffer next year, as his main competitor has recently purchased new brewing technology. While his own brewing equipment is only 10 years old, it is unable to produce the new variety of beers that customers are demanding, and maintenance and operating costs are increasing.

Sharp is considering a proposal to invest $10 million in new equipment. This will probably increase next year’s operating profit for his division by $10 million. Sharp has analysed the future cash flows of this proposal, and the new acquisition will easily satisfy the minimum required rate of return of 10 per cent for all new investments that is set for the Bonavista Group. Without this acquisition, Sharp expects his divisional profit ROI to drop to 13 per cent next year.

The financial data for the last year and the latest forecast for the current year, for each division, in thousands of dollars, as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|   | **Operating profit** |  | **Sales revenue** |  | **Divisional assets** |  | **Target ROI** |
| **Division** |  |   |  |   |  |   |  |
|   | Lastyear | Currentyear |   | Lastyear | Currentyear |   | Lastyear | Currentyear |   | Lastyear | Currentyear |
|   Newspaper | 627   | 744   |   | 2,728   | 2,740   |   | 5,700   | 6,200   |   |  11%   | 11%    |
|   Brewing | 1,134   | 1,232   |   | 4,890   | 4,640   |   | 6,300   | 7,700   |   |  17%    | 15%    |
|   Cable | 160   | 336   |   | 1,940   | 990   |   | 8,000   | 8,400   |   | 1%    | 2%    |
|  |

Requirements

Assume that you are a management consulting team hired by Bonavista International, to review and redesign the performance measurement system. Your team is required to submit a written report covering following aspects:

* Explain why Karl Sharp is reluctant to invest in the new brewing equipment (Provide calculations to support your arguments)
* Explain the limitations of the key financial performance measure/s and incentive systems used by Bonavista international (Use above calculations to support your arguments). I have completed these calculations below

|  |  |  |  |
| --- | --- | --- | --- |
| Newspaper   | **Last Year** | **Current** | **Change** |
| Operating Profit  | $                          627,000.00  | $                        744,000.00  | 18.66% |
| Sales Revenue  | $                       2,728,000.00  | $                     2,740,000.00  | $               12,000.00  |
| COGS | $                       2,101,000.00  | $                     1,996,000.00  | $         (105,000.00) |
| Assets | $                       5,700,000.00  | $                     6,200,000.00  | $            500,000.00  |
| Profit Margin | 22.98% | 27.15% | 4.17% |
| ROA | 47.86% | 44.19% | -3.67% |
| ROI  | 11.00% | 12.00% | 1.00% |
| Shares Awarded | $                            74,000.00  | $74,000.00 & 24000Shares | 148000 |
|  |  |      |  |
| **Brewing** | **Last Year** | **Current** | **Change** |
| Operating Profit  | $                       1,134,000.00  | $                     1,232,000.00  | 9% |
| Sales Revenue  | $                       4,890,000.00  | $                     4,640,000.00  | $         (250,000.00) |
| COGS | $                       3,756,000.00  | $                     3,408,000.00  | $         (348,000.00) |
| Assets | $                       6,300,000.00  | $                     7,700,000.00  | $        1,400,000.00  |
| Profit Margin | 23.19% | 26.55% | 3.36% |
| ROA | 77.62% | 60.26% | -17.36% |
| ROI  | 18.00% | 16.00% | -2.00% |
| Shares Awarded | $74,000.00 & 24000 Shares  | $74,000.00 & 24000 Shares |  |
|  |  |  |  |
| **Cable** | **Last Year** | **Current** | **Change** |
| Operating Profit  | $                          160,000.00  | $                        336,000.00  | 110% |
| Sales Revenue  | $                       1,940,000.00  | $                        990,000.00  | $         (950,000.00) |
| COGS | $                       1,780,000.00  | $                        654,000.00  | $      (1,126,000.00) |
| Assets | $                       8,000,000.00  | $                     8,400,000.00  | $            400,000.00  |
| Profit Margin | 8.25% | 33.94% | 25.69% |
| ROA | 24.25% | 11.79% | -12.46% |
| ROI  | 2.00% | 4.00% | 2.00% |
| Shares Awarded | $74,000.00 & 48000 Shares  | $74,000.00 & 48000Shares |  |