University of Waterloo

Vershire Company

AFM 482: Performance Measurement and Organizational Control

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Vershire Company

Vershire Company is a large business in the packaging industry with several major divisions. The focus of this report is on the aluminum can division and its control systems including the budgeting process and performance measurement. This division is one of the largest manufacturers of aluminum beverages cans in the United States. However, if customers' expectations for cost, quality, and service are not met, they can easily purchase from another manufacturer. Therefore, it is important for Vershire to keep tight control over their plants, budgets, and performance in terms of efficiency and effectiveness. The major concern currently facing Vershire Company is that each plant within the division is being treated as a profit centre, rather than an engineered expense centre. As a manufacturing plant, in which outputs produced are quantifiable in terms of units produced, there is a need to focus on expenses rather than profit. This error in classification is the root of many other control, communication, and performance measurement problems.

Strengths and Weaknesses of Vershire's Planning and Control System

When developing a budget or forecasting future performance, it is important to have a structured process in place. At a high level, Vershire uses a planning and control system that has strengths and weaknesses, which will be further analyzed below.

Planning System

Strengths:

When formulating the sales budget, divisional managers are required to predict market conditions and capital expenditures five years out and prepare a forecast for the subsequent two years. This is a good way for the divisions and the company as a whole to anticipate sales, income, and capital requirements that are necessary to make future decisions and remain competitive. This forward looking approach allows the company to design its long-term goals and objectives.

In addition, the forecasting is done at the corporate level and is then sent to the divisional managers for fine-tuning. This allows divisional managers to have input in the budget, which enhances the quality of the budget since divisional managers have a more realistic outlook on what sales will be for the coming year. As well, since their performance is tied to these budgets, it is important for them to feel involved in its preparation.

Thirdly, corporate controllers visit each plant for half a day prior to the final submission of the budget. During this visit, plant managers have the opportunity to explain their situation and discuss in detail specifics that affect their plants. This will allow for a more accurate and complete budget to be produced.

Weaknesses:

The initial sales forecast uses assumptions such as inventory carryovers, forward buying, packing trends, etc., which are entirely derived from corporate headquarters' analyses. As divisional managers are in charge of managing the operations of each division, they should be given the responsibility of making their own detailed sales forecast and getting approval from corporate head office on the final numbers. This will increase the overall accuracy of the initial forecast, making it less subject to change during subsequent reviews of the budget and creating a more efficient process.

Secondly, the forecasting method is the same for all product lines. This is not an effective way of forecasting as each division or product line has different factors that affect its sales such as demand of customer base, industry trends, product characteristics, etc.

Finally, plant managers do not come up with the sales budgets – the district sales managers do. After this is done, the budgeted sales are handed down to the plants after which each plant budgets gross profit and pretax income. However, plant managers are held responsible for the budgeted profit numbers as their performance is tied to the profit that their plant generates. This is a weakness as the plant managers are held accountable for profits when they do not have control over all the profit components, mainly the sales side of the equation.

Control Systems

Strengths

Divisional managers are given full control over their divisions except in the areas of raising capital and labor relations. This process is efficient as it allows the different divisional managers to take full responsibility for the divisions and make decisions that can best achieve the division's goals, objectives, and performance forecast. Also, leaving labor relations and capital to the corporate head office allows the company to enjoy the benefits of operating as a large organization and economies of scale, such as the ability to obtain preferred interest rates from financial institutions. The divisions are then also able to focus on activities more central to the profit objectives emphasized by the company.

Secondly, there is timely communication between the various hierarchies of the company as there are not that many tiers - plant managers report to the divisional managers who then report to the corporate office. Finally, there is constant oversight on meeting the budget, as plant managers are required to perform a variance analysis explaining differences each month and are expected to anticipate large variances on a daily basis.

Weaknesses:

Profit is the main measure for assessing plant managers' performance and determining bonuses. This is not an effective incentive measurement since there are other factors that determine the capabilities of a plant manager. Even if sales fall below the budgeted levels, it is still the plant manager's responsibility to achieve the budgeted profit levels. In addition, determining the efficiency of plant managers by comparing different divisions does not give accurate measures since plants have different product lines. This weakness in performance evaluation is discussed in more detail later in the report.

Profit Budgeting Process at Vershire

The table below shows the profit budgeting process, with a rationale for each activity as well as who is responsible for that step. In addition, please refer to the Appendix for an overview diagram of this process at Vershire.

Date	Responsible	Action	Rationale
May	Divisional General Manager	1) Summarize outlook for sales, income, and capital requirements for the next budget year 2) Evaluate trends anticipated in each category over the subsequent two years	• The Divisional General Manager has the broadest knowledge about his/her region; therefore, he/she is utilized to make the preliminary forecasts • By evaluating the outlook, areas for improvement or investment can be identified
		3) Submit the preliminary report to Corporate Management	
	Central Market Research Staff	1) Examine next budget year in detail 2) Examine following two years in general terms	• Use the Divisional General Manager's forecasts to develop a more formal market assessment
		3) Prepare a sales forecast for each division: • Consider economic conditions and their impact on customers, and market share for different products by geographic area. • Make assumptions for price, new products, changes in particular accounts, new plants, inventory carryovers, forward buying, packaging trends, industry growth trends, weather conditions, and alternative packaging.	• Ensure that basic assumptions are uniform throughout the entire company • Determine areas for additional capital expenditure • Assess competitive position and areas for improvement • Determine areas where market share can be increased • Determine any opportunities for new products
		4) Aggregate divisional forecast into a company forecast	• Ensure that overall corporate sales forecasts were reasonable and achievable
		5) Submit forecasts to respective Divisional General Managers	
	Divisional General Manager	1) Compile new sales forecasts	• Determine need for additional investments
		2) Request input from District Sales Managers	
	District Sales Manager	1) Estimate sales forecasts for the upcoming year • Request help from Head Office or divisional	• The District Sales Manager has the most knowledge about the sales so better

		staff (optional)	estimates can be made
		2) Submit sales forecasts to Divisional General Manager	
	Divisional General Manager	1) Consolidate sales forecasts	
		2) Submit to Vice President of Marketing	
	Vice President of Marketing	1) Review consolidated sales forecasts	• Ensure that the consolidated sales forecasts are consistent with the knowledge of the Vice President of Marketing, who has a broader view of the sales
		2) Make amendments with approval of district manager (if necessary)	
		3) Submit to corporate level	
	Corporate	1) Review consolidated sales forecasts	• Ensure that the forecasts are aligned to the corporate strategy and identify any areas for improvement
		2) Make amendments with approval of district manager (if necessary)	
		3) Approve budget as a fixed objective	
		4) Translate consolidated budget into a sales budget for each plant from which the finished goods would be shipped	• Sales budget is divided amongst the plants from which finished goods would be shipped, as these are where the revenue is generated. Performance is measured mainly by profit.
		5) Submit plant sales budget to Plant Manager	
	Plant Manager	1) Categorize budget according to price, volume, and end use	• Separate product lines so that costs can be budgeted according to each product
		2) Budget gross profit, fixed expenses, and pre-tax income	
		3) Request cost budget from the plant's Industrial Engineering Department	
	Industrial Engineering Department	1) Develop cost standards and cost reduction targets including budgeted cost reductions, allowances for unfavourable variances from standards, and fixed costs such as maintenance labour.	• The Industrial Engineering Department sets these costs for all plants; therefore, the thresholds should be consistent across all plants and makes them more comparable
		2) Submit to Plant Manager	
	Plant Manager	1) Compile input from Industrial Engineering Department into budget	
	Head Office Controller Staff	1) Visit plant and walkthrough	• Allow Controllers to familiarize themselves with the plant processes

		2) Review budget with plant manager and any supervisors	• Provide Plant Managers to explain the basis of their budgets • Ensure that Plant Managers are in line with the corporate goals • Reinforce plant connection and communication with Head Office
September	Plant Manager	1) Submit plant budgets to Division Head Office	
	Division Head Office	1) Consolidate plant budgets to a division budget	
		2) Submit to Divisional General Manager	
	Divisional General Manager	1) Review division budget	
		2) Return budget to Plant Manager for revisions (if necessary)	• Determine areas where cost efficiency can be improved so that there is a larger gross margin
	Plant Manager	1) Revise budget for any additional savings	• Since the plant manager has the most knowledge of the operations, they should determine any areas for additional savings
		2) Submit to Divisional General Manager	
	Divisional General Manager	1) Approve budget	
		2) Submit budget to the Chief Executive Officer	
	Chief Executive Officer	1) Request modifications to the budget (if necessary)	• Ensure that the budget is consistent with the overall corporate strategy and goals
		2) Approve budget	
December		3) Submit final budget to Board of Directors	
	Board of Directors	1) Approve final budget	

Should the Plant Managers be Held Responsible for Profits

Profit is made up of two components, revenue and expense. Plant managers should be responsible only for the measures that they can directly control, which are the expenses. This includes direct materials, direct labor, variable manufacturing and fixed overhead budget. The plant itself should be considered an engineering expense centre as there are no direct revenues generated from the plant rather the revenue is generated in the sales department. This is an important factor when monitoring management compensation for improved plant performance.

"The plant manager was held responsible for the budgeted profit number even if actual sales fell below the projected level." However, sales department has sole responsibility for the price, sales mix and delivery schedules and each of these components can have a direct impact on profitability, more specifically revenue. As well, any difference of opinions between sales and production is always favoured with the sales department as Vershire wants to satisfy the customer since they can easily switch to a competitor. This reduces the plant manager's ability to maintain control over profitability in the plant since production can be disrupted by the sales manager and hurt efficiency of outputs; resulting in higher costs.

Prior to budget submission, head office controller staff visits the plants and the plant manager has the opportunity to explain his/her situation. The plant managers can vocalize any concerns or unanticipated/unaccounted issues not captured in the current budget. The ability to express concerns helps to slightly mitigate the lack of control that plant managers have over the sales side of the budgeted profit.

The incentive program for plant managers is as follows:

- Only capable managers were promoted with profit performance being the main factor
- Compensation package was tied to achieving profit budgets
- Plant efficiency reports were highly publicized even though different shops had different set up times

These profit-oriented incentives motivate plant managers to act in the best interest of the corporation. For example, if the managers' incentives focused only around output and cost, they might be inclined to refuse to accommodate the sales department when they had special orders that altered production schedules and output. The incentives are well aligned with the corporate goal of maximizing profit.

However, as plant managers have little influence over revenue decisions, holding them entirely accountable for profitability is not appropriate.

Assessment of the Performance Evaluation System in Ex. 2/3

The performance evaluation system contained in Exhibit 2:
Exhibit 2's main focus is net profit, which is influenced by both sales and expenses. The exhibit includes variances regarding sales price, sales mix, and sales volume. These are items that the

sales department has responsibility over, rather than the plant manager. Therefore, they are evaluating plant managers based on metrics over which the plant managers have no direct control. Vershire fails to properly evaluate not only efficiency, but also effectiveness. In a manufacturing environment, both elements use output as a means of evaluation. By looking at output in terms of profit rather than the quantity produced, the evaluations become irrelevant. While the cost variances present in Exhibit 2 would be a more accurate performance measure, they are viewed in terms of sales rather than production. As plant managers cannot control sales, these variances then become irrelevant. Overall, the performance evaluators contained within exhibit 2 do not accurately measure the effectiveness or efficiency of the aluminum can manufacturing plants.

The performance evaluation system contained in Exhibit 3:
The individual plant level reports contained in Exhibit 3 give a more detailed analysis of the variances in Exhibit 2. As stated above, these variances fail to properly evaluate plant managers, and as such further detail is just irrelevant.

The division level reports focus on net sales, including price and mix changes, as well as gross margin. As stated above, net sales are controlled by both sales and costs. Plant managers only have the ability to control costs, and as such these reports also lack relevance in terms of evaluating their performance.

The manufacturing division level report also is an inadequate performance evaluation report; as it compares plants that produce different products and that have varying setup times. This makes any analysis unreliable.

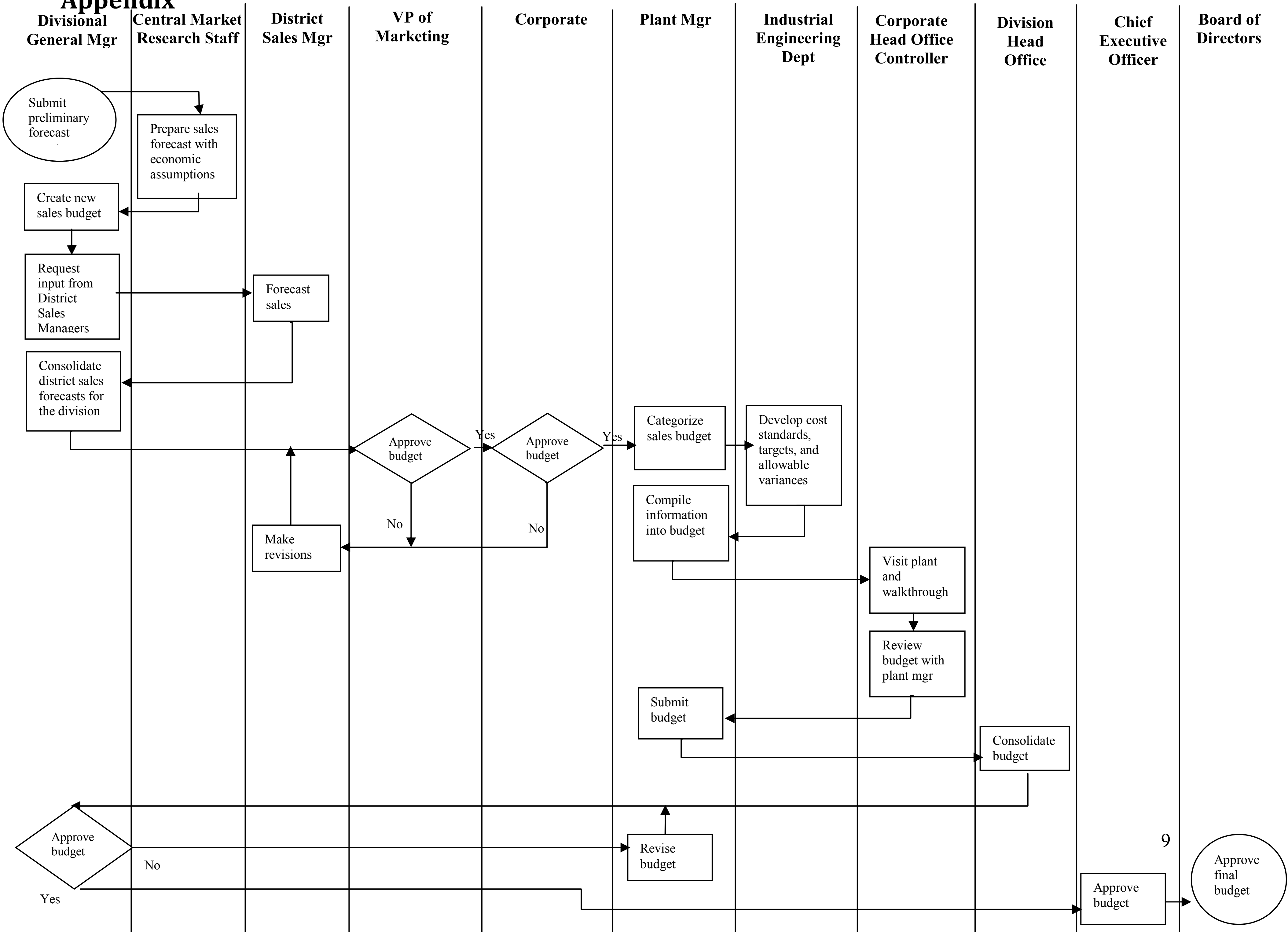
By using these performance evaluators to assess the plant managers' performance in each plant, they are penalizing them for the shortfalls of the sales department and its inability to sell what is produced. Alternatively, the company is also rewarding the plant managers when the sales department is able to negotiate favorable contracts for the company. When looking at the metrics within the exhibits, they would be excellent measures if they were used to evaluate the performance of those individuals that have direct control over the metrics. Given that they are used for the plant manager, they are nowhere near adequate.

Redesign the Management Control Structure at Vershire Company

Given the criticisms of Vershire Company's sales budget, manufacturing budget, performance measurement and management incentives, there are several changes that need to be applied in order to make the management control structure a better one. The recommendations, specific actions and their corresponding benefits are provided in the table below:

Recommendation	Specific Actions	Benefits
More communication and meetings between corporate HQ and among division general managers	● Holding a company-wide meeting of division general managers and corporate HQ in order to discuss the upcoming year's sales budget ● Having division marketing managers assist corporate HQ in developing division forecasts instead of HQ making general assumptions ● Create more channels of communication among division general managers	● Reminds division general managers of the overall goals of the company ● Provides a holistic view of the company and the status quo ● Facilitates brainstorming of new products or ideas ● Discuss similar issues plaguing several divisions ● Facilitates knowledge and resource sharing among divisions and corporate HQ ● Facilitates the sales budgeting process by minimizing errors
Alter how plant managers are compensated and reassign responsibility over profits	● Realign plant manager compensation packages so that it is tied *largely* to cost or manufacturing efficiency and a lesser extent to profit ● Tie district sales managers' compensation packages to profit ● Add adjustments for extra costs associated with sales manager or high level management decisions ● Add adjustments for costs associated due to "acts of nature" such as a fire	● Motivates plant managers to maximize profit using a variable they can control, which is cost ● Protects the plant manager against adverse factors out of his/her control ● Enables the plant managers and sales managers to collaborate towards maximizing the bottom line (profits) ● Achieves better goal congruence
Improve comparisons of manufacturing efficiency between divisions and plants	● Compare manufacturing efficiency between plants and divisions using a more comparable metric ● If such a metric does not exist then a new metric could be developed to solve this issue ● Reward most efficient plant and division	● More efficient plants or divisions could be 'studied' and a knowledge base could be created ● Facilitates knowledge and resource sharing among plants and divisions ● Increase in efficiency will contribute to the corporate bottom line ● Achieves better goal congruence

Appendix



Divisional General Mgr
Central Market Research Staff
District Sales Mgr
VP of Marketing
Corporate
Plant Mgr
Industrial Engineering Dept
Corporate Head Office Controller
Division Head Office
Chief Executive Officer
Board of Directors
Submit preliminary forecast
Prepare sales forecast with economic assumptions
Create new sales budget
Request input from District Sales Managers
Forecast sales
Consolidate district sales forecasts for the division
Approve budget
Yes
Approve budget
Yes
Categorize sales budget
Develop cost standards, targets, and allowable variances
Compile information into budget
No
No
Make revisions
Visit plant and walkthrough
Review budget with plant mgr
Submit budget
Consolidate budget
Approve budget
No
Revise budget
Yes
Approve budget
Approve final budget