

Axeon n.v. essay sample

[Business](#), [Company](#)



This report presents a case involving problems at a chemical manufacturing firm, Axion N. V. having grown into a multinational Company, problems have emerged; do to ineffective performance measurement systems and lack of strategic control. The following management report describes and analyses those problems and presents solutions and recommendations.

With headquarters in the Netherlands, Axion N. V. operates three subsidiaries; in the U. K. Scandinavia and Southern Europe. The subsidiaries have considerable autonomy to determine their product mix and the setup of new manufacturing facilities. Case analysis revealed serious defects in the Company's operation resulting from poorly designed performance measurement systems and inefficient strategic control. These defects have led the Company to reward subsidiary managers for focusing solely on their subsidiaries short-term revenue and profit but not for contributing to the long-term optimization of shareholder returns.

The case also presents an apparently profitable proposal, made by the U. K. subsidiary, that subsequent an approval by the board of directors becomes a matter of controversy as its alleged profitability is questioned by management at Axion's headquarters. Case analysis reveals that not only is the proposal incorrectly constructed but is furthermore unprofitable and would not have been presented if proper performance management systems had been in place. This report recommends rejection of the above mentioned proposal and that Axion implements effective performance management systems to ensure congruency of management and Company goals.

About the Company Axion N. V is a multinational Company specializing in the manufacturing of industrial chemicals. With headquarters in the Netherlands, the Company has over the years acquired subsidiaries in the U. K., Italy and Sweden. The subsidiaries are responsible for sales in the U. K., Southern Europe and Scandinavia, respectively, accounting for 8%, 14% and 6% of Axion's total sales. All other sales are handled by Axion in the Netherlands.

The Company emphasizes decentralization, allowing subsidiary managers considerable autonomy regarding what products to sell in their territories. Products manufactured by one subsidiary are sold to other subsidiaries at the same price as to agents. In some cases, the subsidiaries manufacture products that compete with those produced by Axion's factories in the Netherlands and little attempt has been made to rationalize the production.

Subsidiaries are allowed to determine their own product mix, propose new products and the setup of new manufacturing plants, if they can justify the investment in their own market.

Management personnel are rewarded with bonuses based on growth of division revenue and for reaching economic profit targets set for the division during the annual planning and budgeting process.

New Product and Plant Proposal In 1998, the Managing Director of Axion's U. K. division, came up with a plan to set up a manufacturing plant in the U. K. for a chemical called AR-42. Even though the chemical was already

manufactured by Axion in the Netherlands, it had never before been sold in the U. K.

The U. K.'s subsidiary's plan was based on a new technology, designed by the subsidiary, to store and apply AR-42. The U. K. subsidiary manager claimed that with this new technology the subsidiary would rapidly develop a 400 ton annual market for AR-42 in the U. K., almost as large as Axion's, already existing, 600 ton, worldwide market for the chemical.

Having designed the plant with assistance from the Corporate Engineering Division in the Netherlands, the U. K. Managing Director presented his plans to the U. K. division's board of directors. Since the plans indicated that the endeavor was profitable, the plan was accepted and subsequently presented to the board of Axion in the Netherlands that voted unanimously to allow construction of the plant. Subsequent discussions among managers at the headquarters caused Axion's managing director to start doubting the proposal's actual profitability and strategic relevance. To support these doubts even further, detailed analysis, done by key managers at the headquarters, indicated that the proposal was indeed uneconomical.

Situational Analysis The conflict presented in this case is caused by the fact that the Company has grown from being a small, simple operation, into a complex multinational, without ever implementing proper strategic control and performance evaluation systems. When analyzing the underlying elements, it is apparent that the Company's performance control system was counterproductive, causing subsidiaries to compete with one another, as if they were outside competition. Managers were rewarded based on the

performance of their own subsidiary alone and not on the basis of Axeon as a whole. In other words: The Company was rewarding A when wanting B.

Fundamental Analysis of the Proposal The circumstances surrounding the proposal to manufacture AR-42 in the U. K., clearly manifest the flawed performance control system, mentioned above. After reviewing the arguments set forth, it is clear that the U. K. management would receive a greater reward for manufacturing and selling AR-42 themselves, than if they would buy it for resale from the factory in the Netherlands. On the other hand, managers in the Netherlands would have been rewarded if the U. K. did not manufacture the chemical but would have bought it from the Netherlands.

However, whereas the U. K. subsidiary neither had experience in manufacturing or selling the chemical, Axeon in the Netherlands had considerable experience in both. Furthermore, the AR-42 factory in the Netherlands could manufacture the 400 tons that the U. K. subsidiary planned to sell in the U. K., without any further capital investment.

Axeon in the Netherlands, with all its experience, was only selling 600 tons of AR-42, worldwide. It therefore seems quite a stretch to imagine that the inexperienced U. K. subsidiary would be able to get their sales up to 400 tons in the U. K. alone, as indicated in the plan. The claim that the subsidiary had designed new technology to store and apply the chemical could however be a proper rationalization for this optimistic forecast. Never the less, this only means that the U. K. subsidiary should have shared this new technology with Axeon in the Netherlands; enabling Axeon, to benefit from the worldwide

increase in sales of AR-42, resulting from this new technology. As pointed out by Axeon's director of manufacturing in the Netherlands, the overhead cost of manufacturing the chemical in the U. K. would always be higher than if manufactured in the Netherlands, due to economies of scale. The manufacturing could take place in the Netherlands without any further capital investment. Due to mass purchases, both fixed and variable cost per ton would become dramatically lower as well as the cost of raw material and material handling.

If the U. K. subsidiary would set up facilities to manufacture AR-42, the economies of scale for Axeon's factory in the Netherlands would make their transfer price to the U. K. subsidiary very close to U. K.'s variable cost thus making it more economical for the U. K. subsidiary to buy AR-42 from the Netherlands than to manufacture it in-house. Due to the geographic proximity, transportation would be a non-critical factor.

Based on the arguments above it is clear that limiting the manufacturing of AR-42 to the factory in the Netherlands is the most economical approach. Based on this, the proposal to set up AR-42 manufacturing facilities in the U. K. should be rejected.

Financial Analysis of the Proposal Analysis of the proposal set forth by the U. K. subsidiary (Exhibit 1) reveals various flaws that further undermine the claim that setting up an AR-42 manufacturing facility in the U. K. is profitable.

Several issues can be pointed out: 1. The proposal's calculation of the NPV of future cash flows should use the Company's required rate of return (12%) but not the 8% loan interest. This dramatically lowers the projects NPV.

2. The plan calls for major plant renovations at the end of year seven. The forecast therefore ignores Relevant Outflow; i. e. it only accounts for the sale price of the old plant but does not take into account the price of a new one. For simplification, this can be nullified by simply ignoring the projected capital inflow, resulting from the sale of the old facility. This lowers the presented NPV even further.

3. The proposal's plant depreciation is too fast. A straight-line annual depreciation should equal: $\text{Annual Depreciation} = (\text{original cost} - \text{residual value}) / (\text{service life})$ or $(£1400,000 - £1030,000) / 7 \text{ years} = £52,000$, which is considerably much less than the £280,000 depreciation used in the proposal. This lowers the proposal's depreciation tax shield and further lowers the presented NPV.

4. The proposal indicates plans to borrow the capital required to set up the plant. Since the tax shield effect of interests are accounted for in the required rate of return it does not need to be accounted for in the NPV. However, no provisions are made for payment on the loan principal in the NPV calculation. Such provisions would affect the operating cash flow, further lowering the NPV. Correcting the original proposal, according to the items above, reveals that the proposal is un-economical. The corrected NPV is negative or, -£242,703 and the IRR is only 8%, far below the required 12%.

Conclusion The conclusion is that the proposal to build an AR-42 plant in the U. K. should be rejected on the basis that it was not only incorrectly calculated but also uneconomical and would result in a loss for the Company.

Given the evidence presented in the proposal, the boards of both the U. K. subsidiary and the headquarters should have accepted the proposal in principle calling for in-depth analysis by other managers and even a third party. To prevent issues like this, it must be realized that Axelon's problems are a result of a lack of proper performance measurement systems and inadequate strategic control. Strategy defines the critical success factors; if those factors are measured and rewarded; people are motivated to achieve them. In order to prevent situations similar to the one presented in this case, it must be recognized that the main goal is to optimize shareholders returns. However, optimizing the short-term profitability of individual subsidiaries does not necessarily ensure optimum shareholder return since shareholder value represents the net present value of expected future earnings.

The need for ongoing feedback and management control requires companies to measure and evaluate business unit performance at least once a year. However, relying solely on such financial measures is inadequate and can, in fact, be dysfunctional. It can for example cause managers to focus only on the short-term gain of their own unit at the expense of the long-term profit of the whole.

The solution is to measure and evaluate business unit managers using multiple measures, non-financial as well as financial. Axelon must therefore implement a performance evaluation system to address the needs of the

different stakeholders of the organization. An example of a system that is aimed at this is the balanced scorecard. In that way, business units would be measured and rewarded on the basis of financial elements, customers, internal business, innovation and learning. Business units should be assigned goals in each of those elements and evaluated accordingly. By evaluating subsidiary managers on this broader level, in-house competition and redundancy would be eliminated. Subsidiaries would be rewarded for working in harmony towards the common goal of maximizing shareholder's value – simultaneously fulfilling the needs of all other stakeholders.

Bibliography Harvard Business Review, september- october 1988 –
Measuring Cost Harvard Business School – 9-193-070 – Accounting for
Indirect Costs Harvard Business School – 9-197-076 – Introduction to Activity-
Based Costing