

Chapter

9

Behavioral and Organizational Issues in Management Accounting and Control Systems

After completing this chapter, you will be able to:

1. Understand the meaning of control.
2. Identify the characteristics of well-designed management accounting and control systems.
3. Discuss key behavioral considerations in the design of a management accounting and control system.
4. Explain the human resources management model of motivation.
5. Apply the ethical control framework to decisions.
6. Discuss task and results control methods.
7. Understand how the Balanced Scorecard can be used to align employees to corporate and business unit objectives.
8. Discuss motivation and dysfunctional behavior in management control systems.
9. Discuss the importance of employee empowerment in the design of management accounting and control systems.
10. Recognize the behavioral issues in budgeting.
11. Discuss the links between different incentive systems and performance.

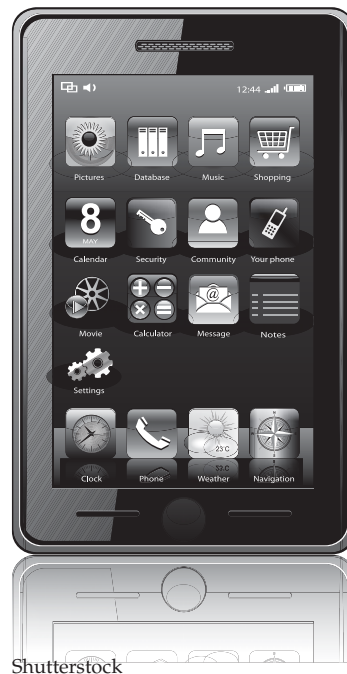
Advanced Cellular International

Wayne Jagielski has just been appointed controller of a large cellular phone manufacturer. He is on the fast track, having graduated with a dual concentration in strategy and management accounting from a large Midwestern business school only four years earlier. Before going back to school, Wayne worked as a management consultant. His most recent job

as a senior manager in one of the manufacturing divisions has been challenging; however, he has performed relatively well despite the low morale of company employees.

On the basis of his experience as a consultant, Wayne has decided to design a management accounting and control system (MACS) that will generate relevant information and motivate the right kinds of behavior from company employees. At a management briefing, Eddie Yueh, a senior vice president, mentioned to him that several managers and their employees were expressing concerns about the proposed changes to the MACS. They wanted to know how the system was designed, whether their performance would be assessed differently, and whether their compensation plans would be altered. They also were uncertain about how the new MACS would affect employee behavior and help achieve organizational strategies.

As he listened to the discussion, Wayne realized that he had committed a major error in his approach—he had not involved enough key people in system design. He wanted to achieve several goals with the new MACS. First, he wanted to design a system whose operation on a day-to-day basis was consistent with the company's ethical and cultural norms of behavior. Second, because the previous system had relied myopically on narrow, short-term financial goals, he wanted to encourage broader thinking for all employees through the use of multiple performance measures. In particular, he wanted to encourage a work environment that fostered creativity. Third—and this is where he had really faltered—he wanted to make sure that people were motivated to work at the company. To this end, he had thought about various types of compensation systems to reward superior performance, but he had not considered asking more employees to participate in overall system design. Would they resist the changes that he was proposing? Could a Balanced Scorecard approach provide some important guidance overall?



WHAT ARE MANAGEMENT ACCOUNTING AND CONTROL SYSTEMS?

The preceding chapters explored different types of cost management systems and the ways the information they generate is used in a variety of decision contexts. A cost management system is the central performance measurement system at the core of a larger entity known as a **management accounting and control system (MACS)**. In this chapter, we discuss the role that MACS play in helping decision makers determine whether organization-, business-, and operational-level strategies and objectives are being met. We begin by presenting the concept of control and then delineate the technical and behavioral characteristics of a well-designed MACS. Further, we discuss how MACS can be used to motivate behavior, how ethical issues are addressed, the possible dysfunctional consequences that can occur when MACS are poorly designed, and how incentives are used.

The Meaning of “Control”

Broadly speaking, a MACS generates and uses information that helps decision makers assess whether an organization is achieving its objectives. The term *control* in management accounting and control refers to the set of procedures, tools, performance measures, systems, and incentives that organizations use to guide and motivate all employees to achieve organizational objectives. A system is in control if it is on the path to achieving its strategic objectives, and deemed out of control otherwise.

For the process of control to have meaning and credibility, the organization must have the knowledge and ability to correct situations that it identifies as being out of control; otherwise, control serves no purpose. As described in Chapter 1, the process of keeping an organization in control consists of the following four stages:

1. **Plan**—Develop an organization’s objectives, choose activities to accomplish the objectives, and select measures to determine how well the objectives were met.
2. **Do**—Implement the plan.
3. **Check**—Monitor by measuring and evaluating the system’s current level of performance; compare feedback about the system’s current level of performance to the planned level in order to identify discrepancies and prescribe corrective action.
4. **Act**—Take appropriate actions to return the system to an in-control state.

Regardless of whether an organization makes video games, helps clean up the environment, or flies people around the world, the same basic control process applies. Where control processes may differ across different types of organizations lies in determining which are the most appropriate types of performance measures to be used. In the following section, we discuss the technical and behavioral characteristics that designers consider when developing a MACS.

CHARACTERISTICS OF A WELL-DESIGNED MACS

Technical Considerations

Technical factors fall into two categories: (1) the relevance of the information generated and (2) the scope of the system. The relevance of information is measured by four characteristics:

1. **Accurate:** As discussed throughout this text, inaccurate information is not relevant or useful for decision making because it is misleading. Designers have to

develop a system that leads to the most accurate information possible, subject to a cost–benefit trade-off. For example, more accurate product costs can be obtained by using systems that trace costs more directly from support activities to products.

2. **Timely:** Accurate information that is late is also of little use for decision making. The MACS must be designed so that the results of performance measurement are fed back to the appropriate units in the most expedient way possible. The proliferation of high-speed computers, local-area networks, and many other forms of technology make the process of providing feedback a real-time possibility in many, if not all, systems.

3. **Consistent:** Designers must structure the MACS to provide a consistent framework that can be applied globally across the units or divisions of an entity. Consistency means that the language used and the technical methods of producing management accounting information do not conflict within various parts of an organization. For example, if two divisions use different costing systems, it is more difficult to understand and compare results across divisions. If one division of an organization uses activity-based costing principles and another division, especially one that is very similar in goals and function to the first, uses volume-based overhead allocation methods, then the information system does not meet the consistency criterion. Consider the difficulties that would arise if divisions classified the same expense differently, that is, if fringe benefits of workers were classified as direct labor expenses in one division but as indirect labor expenses in another.

4. **Flexible:** MACS designers must allow employees to use the system’s available information in a flexible manner so that they can customize its application for local decisions. If flexibility is not possible, an employee’s motivation to make the best decision may be lessened for the decision at hand, especially if different units engage in different types of activities. For example, if one division of a company located in Pasadena undertakes new product development and another division in Monterey performs final assembly, each division probably will have different data needs and may use different cost drivers in making its decisions. The performance measures for managing new product development in Pasadena will be quite different from the factors that the Monterey assembly division must use to manage effectively. A well-designed MACS should be able to accommodate the local needs of each division. If not, inaccurate ad hoc local systems may develop, leading to poor decisions and confusion between the company’s division and upper management.

The scope of the MACS must be comprehensive and include all activities across the entire value chain of the organization. For example, historically, many MACS measure and assess performance in only one part of the value chain—the actual production or throughput process. In this case, the performance of suppliers, the design activities, and the postproduction activities associated with products and services are ignored. Without a comprehensive set of information, managers can make only limited decisions.

Behavioral Considerations

Because human interests and motivation can vary significantly, a major role for control systems is to motivate behavior congruent with the desires of the organization.

The rest of the chapter turns to the second set of characteristics related to MACS design. Four major behavioral characteristics should be considered when designing a MACS:

1. Embedding the organization’s ethical code of conduct into MACS design.
2. Using a mix of short- and long-term qualitative and quantitative performance measures (or the Balanced Scorecard Approach).

3. Empowering employees to be involved in decision making and MACS design.
4. Developing an appropriate incentive system to reward performance.

Wayne Jagielski's dilemma at the beginning of this chapter highlights a key issue that plagues major companies. Although many managers want to do what is best for their companies, they often try to implement new systems without considering the behavioral implications and consequences of using a MACS. Unless they pay careful attention to these factors, goal congruence may not occur, motivation could be low, and, worst of all, employees may be encouraged to engage in dysfunctional behavior.

Note, however, that these four characteristics do not simply arise by accident in every MACS. Rather, companies that have a MACS often subscribe to a particular worldview of the role of management that we label the human resource management model of motivation. The development of this view is discussed next, followed by a detailed discussion of the four characteristics.

THE HUMAN RESOURCE MANAGEMENT MODEL OF MOTIVATION

One of the earliest attempts at understanding the role of management, developed at the turn of the 20th century, was the **scientific management school**. The underlying philosophy was that most people found work objectionable, that individuals cared little for making decisions or exercising creativity on the job, and that money was the driving force behind performance. Management believed that employees should follow highly detailed, prescribed procedures and that behavior should be monitored and controlled very carefully through time-and-motion studies.

The **human relations movement** was the next significant step in the development of managerial views on **motivation**. This movement recognized that people had needs that went well beyond performing a simple repetitive task at work and that financial compensation was only one aspect of what workers desired. Employees wanted respect, discretion over their jobs, and a feeling that they contributed something valuable to their organization. The human relations movement was the impetus for developing ways to improve morale and job satisfaction and the overall quality of working life.

Perhaps the most contemporary management view of motivation is the **human resources model of motivation (HRMM)**. Based on initiatives to improve the quality of working life and the strong influence of Japanese management practices, HRMM introduces a high level of employee responsibility for and participation in decisions in the work environment. The central assumptions of HRMM are that organizations operate under a system of beliefs about the values, purpose, and direction of their organization; that people find work enjoyable; and that people desire to participate in developing objectives, making decisions, and attaining goals in their work environment. Individuals are motivated by both financial and nonfinancial means of compensation. This model also assumes that employees have a great deal of knowledge and information about their jobs, the application of which will improve the way they perform tasks and benefit the organization as a whole. Individuals are assumed to be highly creative, ethical, and responsible, and they desire opportunities to effect change in their organizations.

The human resource model is the basis of the presentation of the four behavioral considerations in MACS design that follows. Next, the organization's ethical code of conduct is discussed.

THE ORGANIZATION'S ETHICAL CODE OF CONDUCT AND MACS DESIGN

A boundary system is a set of standards relating to acceptable behavior in an organization. At the center of many boundary systems is a set of ethical principles, and thus a well-designed MACS should incorporate the principles of an organization's code of ethical conduct to guide and influence behavior and decision making. Ethics is a discipline that focuses on the investigation of standards of conduct and moral judgment. A MACS design that incorporates ethical principles can provide decision makers with guidance as they face ethical dilemmas. Recent scandals in corporate America have greatly heightened the need for a renewed emphasis on ethical judgment and decision making.

Managers often play a significant role in MACS design. Their behavior and decision making are guided by the organization's code of ethical conduct and the ethical standards under which they abide. The ethical framework embedded in system design is extremely important because it will influence the behavior of all users. The key user group—managers—interacts a great deal with the MACS. Often managers are subject to intense pressures from their job circumstances and from other influential organizational members to suspend their ethical judgment in certain situations. These pressures include the following:

1. Requests to tailor information to favor particular individuals or groups.
2. Pleas to falsify reports or test results.
3. Solicitations for confidential information.
4. Pressures to ignore a questionable or unethical practice.

To incorporate ethical principles into the design of a MACS and help managers deal effectively with the types of situations listed above, system designers might attempt to ensure the following:

1. That the organization has formulated, implemented, and communicated to all employees a comprehensive code of ethics. This is often accomplished through the organization's beliefs system.
2. That all employees understand the organization's code of ethics and the boundary systems that constrain behavior.
3. That a system in which employees have confidence exists to detect and report violations of the organization's code of ethics.

Avoiding Ethical Dilemmas

Most organizations attempt to address ethical considerations and avoid ethical dilemmas by developing a code of ethics. Although no universal hierarchy of ethical principles exists, five categories capture the broad array of ethical considerations: legal rules, societal norms, professional memberships, organizational or group norms, and personal norms.

This hierarchy is listed in descending order of authority. For example, an action that is prohibited by law should be unacceptable by society, by one's profession, by the organization, and then by each individual. However, an action that is legally and socially acceptable, such as strategically underestimating product costs, may be professionally unacceptable and, in turn, unacceptable to the organization and its employees. Unfortunately, any hierarchy of this sort has a number of gray areas, but it nevertheless provides general guidelines for understanding and dealing with ethical problems that arise.

This ethical hierarchy provides a set of constraints on a decision. In this scheme, ethical conflicts occur when one system of values diverges from a more fundamental system. For example, suppose that the organization's code of ethics commits it to meeting only the letter of the law regarding disclosure of a product defect in one of its manufactured goods that could prove hazardous to consumers. However, a broader societal expectation is that organizations should be aggressive in identifying and disclosing potential product defects. An individual decision maker dealing with this situation may face an ethical conflict when the organizational code of ethics implies doing nothing about the defect since there is no definitive evidence of a product problem. In such cases, broader societal expectations would imply that disclosure is necessary because there is persistent evidence of a problem.

Dealing with Ethical Conflicts

Organizations that formulate and support specific and unambiguous ethical codes can create an environment that will reduce ethical conflicts. One step in avoiding ambiguity or misunderstanding is to maintain a hierarchical ordering of authority, which means that the organization's stated code of ethics should not allow any behavior that is either legally or socially unacceptable. Because most professional codes of ethics reflect broad moral imperatives, such as loyalty, discretion, and competence, an organization would create public relations problems for itself if its stated code of ethics conflicted with a professional code of ethics.

Another critical variable that can reduce ethical conflicts is the way in which the chief executive and other senior managers behave and conduct business. If these individuals demonstrate exemplary behavior, other organizational members will have role models to emulate. Organizations whose leaders exhibit unethical behavior cannot expect their employees to behave according to high ethical standards.

In some cases, when organizations develop a formal code of ethics, they can create the potential for explicit ethical conflicts with the code itself to arise. The conflicts that appear most in practice are those between the law and the organization's code of ethics, between the organization's practiced code of ethics and common societal expectations, and between the individual's set of personal and professional ethics and the organization's practiced code of ethics. Any conflicts that remain relate primarily to personal values and norms of behavior that were acceptable prior to the adoption of the organization's new code of ethics but that are now in question.

Conflicts between Individual and Organizational Values

People bring personal codes of ethics with them into an organization. If the organization's code of ethics is more stringent than an individual's code, conflicts may arise. However, if adherence to the organization's ethical code is required and enforced, it is possible to diminish ethical conflicts if, as part of the employment contract, the individual is asked and expected to pursue a more stringent code of ethics. Another possible (and probably more desirable) outcome is that individuals may raise their own ethical standards without conflict.

Difficult issues may arise when an individual's personal code of ethics prohibits certain types of behavior that are legal, socially acceptable, professionally acceptable, and acceptable to the organization. Potential for conflicts in such situations will arise when the action that is unacceptable to the individual is desirable to the organization. As an example, an employee may have deep religious objections to conducting business in any form on a holy day. Working for an organization may require that the

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Does Cheating at Golf Lead to Cheating in Business?

Almost a decade ago, Starwood Hotels and Resorts commissioned a study of high-ranking corporate executives to see if they were less than honest on the golf course. The results of the study showed that 82% of these executives admitted to various kinds of cheating behavior. Another informal study of a dozen CEOs polled by *USA Today* revealed that these CEOs also bent the rules when they play, in part, because they saw their competitors doing the same.

Are there consequences for this behavior? Jeff Harp, former president of Summit National Bank in Fort Worth, Texas, states that he has denied loans after seeing CEOs cheat at golf. Since he is in the business of trying to assess honesty, he feels that if one can cheat at golf, one can cheat on a loan application. However, there may be a bigger societal issue.

Ken Siegel, an organizational psychologist who has been interviewing executives for 25 years, says that executives who cheat and lie and then deny it may be deluding themselves and others. "They lose the ability to distinguish what is honest and what is not," Siegel says. "Lies are getting bigger and bigger. We're seeing this played out everywhere now, from Tyco to Enron."

In 2009 another study was conducted by Duke University. A survey of 17,000 golfers found that there were four kinds of cheating behavior: stating that you got a lower than actual score on a hole, moving a ball slightly to improve your lie, claiming you lost your first ball and dropping a second ball, and kicking your ball to a better position.

David Rynecki, an author who has written extensively about golf, says that golf is "an 18-hole character test," from which one can learn a great deal about your competitor. This not only includes whether they cheat or not but how passionate they are and whether they fit with you and your company. Said Dan Ariely, one of the authors of the Duke study, "First of all, I think cheating in golf is kind of a good example for

how we think about day-to-day tasks. The fact that people can take a mulligan or how they can cheat on golf, I think tells us that's there a lot of corner bending that we see in the business world. And what I worry about is that once we start in this path of immorality, even with small bending of rules and cutting corners here and there, that this tendency could become bigger and bigger and really a part of the collective understanding of how business is actually done."

Food for thought.



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Source: Adapted from Del Jones, "Cheating at Golf Is Par for the Course for CEOs," *Salt Lake City Tribune* (June 30, 2002); David Rynecki, "An 18-Hole Character Test," *Business Week* (May 28, 2007): 92–95; and behavioral economist, Dan Ariely, quoted from <http://marketplace.publicradio.org/display/web/2009/10/06/pm-ariely-golf-q>

person, under these circumstances, do things that he or she finds unacceptable. In this case, the individual is confronted with a personal choice. Unfortunately, the employee may have little institutional support in this situation but can lobby within or outside the organization to prohibit working on a holy day. This tactic may be effective, or the affected employee may choose not to work for that organization, depending on what he or she values most. As a practical matter, employees faced with ethical conflicts must make sure to document the events and discussions and list the parties involved so that a case can be made.

Conflicts between the Organization's Stated and Practiced Values

In some cases, employees will observe management or even senior management engaged in unethical behavior, such as management fraud. This type of conflict is the most difficult because the organization is misrepresenting its ethical system, forcing the employee to make a choice between going public with the information or keeping it quiet. In this setting, the employee is in a position of drawing attention to the problem by being a whistle-blower, which many have found to be a lonely and unenviable position. In many instances, though, whistle-blowers have chosen personal integrity over their loyalty to an organization.

Experts who have studied this problem advise that the individual should first ensure that the facts are correct and that a conflict does exist between the organization's stated ethical policy and the actions of its employees in practice. Second, by speaking with superiors, the individual should determine whether this conflict is institutional or whether it reflects the decisions and actions of only a small minority of employees. Faced with a true conflict, the individual has several choices, including the following:

1. Point out the discrepancy to a superior and refuse to act unethically. This may lead to dismissal, the need to resign from the organization, or the experience of suffering hidden organization sanctions.
2. Point out the discrepancy to a superior and act unethically. The rationale for this choice, which is incorrect, is that the employee believes that this affords protection from legal sanctions.
3. Take the discrepancy to a mediator in the organization if one exists.
4. Work with respected leaders in the organization to change the discrepancy between practiced and stated ethics.
5. Go outside the organization to publicly resolve the issue.
6. Go outside the organization anonymously to resolve the issue.
7. Resign and go public to resolve the issue.
8. Resign and remain silent.
9. Do nothing and hope that the problem will dissolve.

Although most experts recommend following alternative 4 on this list, it is beyond the scope of this chapter to discuss the efficacy of any of these alternatives other than to mention that there are circumstances that can make any of them appropriate. If the organization is serious about its stated code of ethics, it should have an effective ethical control system to ensure and provide evidence that the organization's stated and practiced ethics are the same. Part of this control system should include a means for employees to point out inconsistencies between stated practices and ethics without fear of retribution. For example, some organizations rely on an ombudsman, while others rely on the internal audit function or an external auditor. Any organization that does not provide a system to protect employees in these situations either is not taking its code of ethics seriously or has an inadequate ethical control system.

The Elements of an Effective Ethical Control System

To promote ethical decision making, management should implement an **ethical control system**. The elements of an ethical control system should include the following:

1. A statement of the organization's values and code of ethics written in practical terms, along with examples so that the organization's employees can relate the statement to their individual jobs.
2. A clear statement of the employee's ethical responsibilities for every job description and a specific review of the employee's ethical performance as part of every performance review.
3. Adequate training to help employees identify ethical dilemmas in practice and learn how to deal with those they can reasonably expect to face.
4. Evidence that senior management expects organization members to adhere to its code of ethics. This means that management must do the following:
 - Provide a statement of the consequences of violating the organization's code of ethics.
 - Establish a means of dealing with violations of the organization's code of ethics promptly, ruthlessly, and consistently with the statement of consequences.
 - Provide visible support of ethical decision making at every opportunity.
 - Provide a private line of communication (without retribution) from employees directly to the chief executive officer, chief operating officer, head of human resource management, or someone else on the board of directors.
5. Evidence that employees can make ethical decisions or report violations of the organization's stated ethics (i.e., be the whistle-blower) without fear of reprisals from superiors, subordinates, or peers in the organization. This proof usually takes the form of an organization mediator who has the authority to investigate complaints, wherever they lead, and to preserve the confidentiality of people who report violations.
6. An ongoing internal audit of the efficacy of the organization's ethical control system.

Steps in Making an Ethical Decision

Formal training is part of the process of promoting ethical decision making. After gathering the facts relating to a particular decision and evaluating the alternative courses of action, the decision maker can eliminate possible courses of action that are ethically unacceptable. The decision model in Exhibit 9-1 is one approach to eliminating unacceptable alternatives.

In summary, the organization's code of ethics is integral to MACS design. Both designers and users of the system should remember this fact and rectify any deviations from the code of ethics that the system explicitly or implicitly promotes.

Motivation and Congruence

In addition to fostering ethical behavior and decision-making, a central issue in MACS design is how to motivate appropriate behavior at work. When designing jobs and specific tasks, system designers should consider the following three dimensions of motivation:

1. Direction, or the tasks on which an employee focuses attention.
2. Intensity, or the level of effort the employee expends.
3. Persistence, or the duration of time that an employee will stay with a task or job.

Exhibit 9-1

Decision Model for Resolving Ethical Issues

1. Determine the Facts—What, Who, Where, When, How

What do we know or need to know, if possible, that will help us define the problem?

2. Define the Ethical Issue

- List the significant stakeholders
- Define the ethical issues

Identify precisely what the ethical issue is, for example, conflict involving rights, questions over limits of disclosure obligation, and so on.

3. Identify Major Principles, Rules, Values

Determine key principles such as integrity, quality, respect for persons, societal benefits, and costs.

4. Specify the Alternatives

List the major alternative courses of action, including those that represent some form of compromise or point between simply doing or not doing something.

5. Compare Values and Alternatives

Determine if there is one principle or value (or a combination) that is so compelling that the proper alternative is clear, for example, correcting a defect that is almost certain to cause loss of life.

6. Assess the Consequences

Identify short- and long-term positive and negative consequences for the major alternatives. The common short run focus on gains or losses needs to be measured against long-run considerations.

7. Make Your Decision

Balance the consequences against your primary principles or values and select the alternative that best fits.

Consistent with theories of individual motivation, careful attention to motivation is a key step for the organization and its employees to align their respective goals; this alignment is known as achieving **goal congruence**. The alignment of goals occurs as employees perform their jobs well and are helping to achieve organizational objectives; they are also attaining their own individual goals, such as obtaining promotions, earning financial bonuses, or advancing their careers in other ways.

In a frictionless world, as employers and employees align their goals, employers could simply rely on the concept of **employee self-control**, in which employees monitor and regulate their own behavior and perform to their highest levels. Even if goals are aligned, however, different types of tasks require different levels of skill, precision, responsibility, initiative, and uncertainty. In most situations, managers try to establish systems that they do not have to personally monitor on a regular basis. The hope is that if these systems are well designed, the manager has much more time to attend to other concerns. These are called **diagnostic control systems**. These are feedback systems that monitor organizational outcomes and correct any deviations from predetermined performance standards. Typically, there is little debate about the nature of the system, and the systems tend to run in a routine fashion.

However, if a large degree of strategic uncertainty offers threats and opportunities that could alter the operating assumptions of a business, managers have to spend much more time monitoring the decisions and actions of their subordinates. Such a system is called an **interactive control system**.¹ Unlike diagnostic systems, interactive systems force a dialogue among all organizational participants about the data coming out of the system and what action to take.

¹ See R. Simons, *Levers of Control* (Boston: Harvard Business School Press, 1995).

Task and Results Control Methods

At the core of diagnostic and interactive systems are two common methods of control: task control and results control.

Task Control

Task control is the process of finding ways to control human behavior so that a job is completed in a prespecified manner. Task control can be separated into two categories: preventive control and monitoring. In **preventive control**, much, if not all, of the discretion is taken out of performing a task because of the precision required or the nature of the materials involved. For example, tasks that require very careful handling, such as making silicon wafers, or those that use precious metals, such as gold, often are controlled carefully or are performed by machines or computers. This is not to say that machines are infallible but rather that the degree of error is probably less than that experienced with humans. Naturally, as the accomplishment of a task requires increasingly greater judgment, the building of preventive control systems becomes more difficult.

Monitoring refers to inspecting the work or behavior of employees while they are performing a task. Monitoring can be accomplished using listening devices or through surveillance. For example, all of us have experienced the situation in which a (sometimes annoying) phone message tells us that the conversation we are about to have with a company representative may be “monitored to ensure quality control.” Since monitoring, or listening in to a conversation in this case, is often done randomly, the employee does not know when it will occur and thus will be disciplined to act in a consistent, professional manner at all times. Monitoring also can be accomplished using surveillance. For example, cameras or “eyes in the sky” are used to observe the actions and behaviors of croupiers at gambling casinos.

Monitoring, however, can have its negative consequences. Some employees feel that being monitored causes them unnecessary stress. These same employees believe that monitoring also undermines the level of trust between employers and employees.

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Monitoring in the Workplace

For the past decade, the number of organizations that have been installing electronic performance monitoring systems to observe employee behavior at work has been steadily increasing. Estimates are that over a quarter of the entire U.S. workforce works under these systems. In addition, 66% of employers monitor Internet connections and the monitoring of e-mail and phone lines is also on the rise. This Orwellian “Big Brother” concept is supported by companies but denounced by employees.

Companies state that the advantages of such systems are that they improve productivity and the quality of work, they reduce human supervision costs, they overcome issues of subjectivity in performance evaluations, and they help in the security of company information and property.

As you might guess, employees are not very happy about such systems stating that they feel that their privacy is violated, that the organization does not trust them, that it reduces their dignity at work, and creates unnecessary tension and stress in the workplace.

Since it appears that these monitoring systems are here to stay, what can organizations do to help mitigate the negative effects that these systems have on employees? First, the reason for the system should be explained to all employees. Second, employees should be able to participate in system design and implementation. Third, monitoring should be restricted only to performance-related activities and not to other activities (such as lunch or coffee breaks). Fourth, an

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organization should not rely solely on monitoring data to assess an employee's performance and, finally, management should be open to system design changes.



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Source: American Management Association, 2007 *Electronic Monitoring and Surveillance Survey*, retrieved from <http://www.amanet.org/research/2008>

Task control is most appropriate in the following situations:

1. When there are legal requirements to follow specific rules or procedures to protect public safety, such as in the manufacture of prescription drugs and critical aircraft components and in the operation of nuclear power generation facilities
2. When employees handle liquid assets (or other precious assets) to reduce the opportunity for temptation and fraud
3. When the organization can control its environment and eliminate uncertainty and the need for judgment. In such instances, the organization can develop specific rules and procedures that employees must follow.

Results Control

Rather than directly monitoring and directly controlling tasks, results control systems focus on measuring employee performance against stated objectives. For **results control** to be effective, the organization must have clearly defined its objectives, communicated them to appropriate organization members, and designed performance measures consistent with the objectives. For example, salespeople are often evaluated on the basis of the volume of sales they made during a specific time interval. The organization sets standards of performance against which the actual results of an employee's performance are compared. For another example, consider a business unit head who must improve her organization's financial performance relative to a prespecified target.

In some instances, task and results controls are used in tandem. As mentioned, phone calls by company salespeople often are monitored to control behavior; however, in addition, these same salespeople often have a weekly sales quota to reach. This is particularly true of salespeople from major long-distance carriers.

Results control is most effective in the following situations:

1. When organization members understand the organization's objectives and their contribution to those objectives.
2. When organization members have the knowledge and skill to respond to changing situations by taking corrective actions and making sound decisions.
3. When the performance measurement system is designed to assess individual contributions so that an individual can be motivated to take action and make decisions that reflect his or her own and the organization's best interests.

Central to the design of results control systems is the development of a performance measurement system that fully reflects the multiple objectives and goals of an organization. This issue is discussed in the following section.

USING A MIX OF PERFORMANCE MEASURES: A BALANCED SCORECARD APPROACH

The Need for Multiple Measures of Performance: Non-Goal-Congruent Behavior

The old saying "What gets measured gets done" indicates that the ways in which organizations and individuals measure performance send signals to all employees and stakeholders about what the organization considers as its priorities. If organizations choose performance measures without careful consideration, non-goal-congruent behavior can occur. For example, suppose a firm sets up a performance evaluation system that rewards a vendor only on the basis of on-time delivery of a product. In all likelihood, on-time delivery will be the variable on which the vendor's employees will focus. Since this evaluation would not consider the quality of the goods sent, vendors who supply the merchandise may sacrifice quality for the sake of meeting promised delivery dates, or they may quote excessively long lead times to ensure that deliveries are not late. Either action could work to the long-term detriment of the organization and the vendor.

Department store managers have discovered that when salespeople are compensated using sales quotas, their attention is focused on selling as much expensive merchandise as possible. Employees faced with such a situation initially may find that their sales volume is increasing, but as the competition for customers develops, the work environment may become hostile as salespeople dispute about customers or sales. Another consequence of relying solely on commissions as a motivating tool is that other aspects of the sales function, such as straightening merchandise or restocking shelves, may become lower priorities. Also, customers may return merchandise that has been oversold to them.

Dysfunctional Behavior

Occasionally, employees are so motivated to achieve a single goal that they engage in dysfunctional behavior. With respect to performance measurement, **dysfunctional behavior** refers to employees knowingly manipulating or falsifying performance measures. To illustrate, consider again a company whose single performance measure is whether employees attain their sales quotas. If an employee is worried about being fired and if there are no other ways to demonstrate good performance, the employee might alter his or her actions specifically in an attempt to manipulate a performance indicator through job-related acts. This is known as **gaming the performance indicator**.

As an example, a salesperson might ask his coworker to give him credit for the colleague's sales bookings, or the salesperson may have his friends come into the store, buy merchandise, and return it 30 days later. The salesperson might engage in **data falsification** by knowingly altering sales booking records in his or her favor. Data falsification is considered illegal, and the accounting profession has recently witnessed the dire consequences of employees engaged in such activities.

Another form of dysfunctional behavior is **smoothing**, a form of **earnings management** that occurs when individuals accelerate or delay the preplanned flow of data without altering the organization's activities. For example, a manager who is close to meeting a performance target, such as a net income or ROI number, may decide to defer expenses incurred in the current period to a future period. Similarly, the manager may attempt to book future revenues into the current period to increase net income. Over the long term, such behavior will lead to the same bottom-line financial outcomes, but the cost to the organization is that it does not have a clear picture of performance for a defined time period. Excessive amounts of smoothing are probably the result of inappropriate standards or a poorly conceived reward system.

In addition to setting up boundary systems so that employees have a clear understanding of what is considered appropriate and inappropriate behavior, organizations also can design performance measurement systems that encourage the desired behavior. One possibility is to use multiple performance measures that reflect the complexities of the work environment and the variety of contributions that employees make. In many of today's manufacturing and service environments, employees or associates are being cross-trained to perform a variety of tasks. For example, at all of the major automobile manufacturers including Toyota, DaimlerChrysler, Nissan, General Motors, Ford, Honda, and BMW, employees are organized into self-managed work teams that follow a product's manufacture from beginning to end. Thus, organizations have an opportunity to design multiple measures to assess the work that is actually being done. Using multiple performance measures also will cause employees to recognize the various dimensions of their work and to be less intent on trying to maximize their performance on a single target at the expense of other aspects of their jobs.

Using the Balanced Scorecard to Align Employees to Corporate Goals and Business Unit Objectives

In addition to using multiple performance measures, MACS designers have to expand their views of the kinds of performance measures to use. For example, only fairly recently have managers become aware of the need for measures of quality, speed to market, cycle time, flexibility, complexity, innovation, and productivity. Historically, some of these measures, such as quality, were in the hands of industrial engineers, while others, such as speed to market or flexibility, were not measured at all.

Managers should keep in mind other new organizational realities. Faced with increasing competitive pressures, many organizations have begun to move away from traditional hierarchical organizations with many layers of management, referred to as *tall organizations*, to those with fewer and fewer layers, or *flat organizations*. General Electric, for example, has reduced its hierarchical structure significantly. As the barriers between functional areas such as engineering design, manufacturing, accounting, finance, and marketing are eliminated, employees are working increasingly in cross-functional teams.

Another significant corresponding change is the use of business process reengineering, in which designers begin with a vision of what organizational participants would like their process or product to look like or how they would like it to function and then radically redesign it. Such an approach is significantly different from starting

with an existing product or process and then making slight incremental changes. Further, reengineering design changes have led to the need for new informational requirements and measures related to the costs and benefits of innovation. Thus, new measures of performance must take into account group-level performance measures and cross-functional business process measures, not just departmental efficiency and spending measures.

The traditional focus of performance measures in management accounting has been on quantitative financial measures such as cost and profit rather than quantitative nonfinancial and qualitative measures. Examples of quantitative nonfinancial measures include yield, cycle time, schedule adherence, number of defects, market share, and customer retention. Variables such as the image of a product or service, the level of caring of the staff in a hospital, or the reputation of a company are examples of qualitative variables. Although they may be more subjective than quantitative variables, many qualitative variables can now be assessed using psychometric methods developed in the behavioral sciences. Customer satisfaction, for example, is a qualitative measure, which can now be quantified by using psychological scales. Clearly, measures such as customer satisfaction and employee morale are crucial for both the short- and the long-term success of any organization.

Change Management

As discussed in Chapter 2, MACS sometimes have to be redesigned to be congruent with an organization's new strategy. In particular, a firm may develop a new Balanced Scorecard strategy map to communicate and support implementation of the new strategy. Research has shown that the single most important factor in making major changes to an organization is having top management support, often at the level of the CEO and other senior managers. The change process often relies on a champion who is charged with spearheading the process. The most effective champions are those with strong entrepreneurial and communications skills, who have great respect in the organization and have the resources to carry out the change. The champion usually coalesces an implementation team composed of a wide variety of employees with different skills who represent key parts of the organization such as systems, accounting, finance, marketing, human resources, and strategy.

One organizational phenomenon that is often encountered by designers is resistance to change on the part of employees. Employees at all levels may feel threatened as new changes are suggested. One of the biggest threats is the potential loss of jobs or being reassigned to a new job, increases in the amount of work or responsibility in an existing job, changes in the workplace environment, changes in compensation, or just the threat of uncertainty and anxiety.

EMPOWERING EMPLOYEES TO BE INVOLVED IN MACS DESIGN

Empowering employees in MACS design requires two essential elements: allowing employees to participate in decision making and ensuring that employees understand the information they are using and generating.

Participation in Decision Making

Organizations often do not realize that their greatest asset is the people they employ. Encouraging participation has a twofold benefit for organizations. First, research has suggested that employees who participate in decision making evince better morale

and greater feelings of job satisfaction. In many instances, these heightened feelings translate into increased productivity as employees begin to feel that they have some ownership and control over what they do at work.

Second, except in highly automated industries, people (not machines) still perform the major portion of work and have superior information and understanding with regard to how work is best accomplished and, consequently, how to improve products and processes. For example, employees in the Sydney branch of ANZAC Company will know more about the way their branch functions than will the people at central headquarters located in Melbourne. Therefore, MACS designers should strongly consider enlisting the participation of the Sydney employees. The same concept applies within a division. Assembly-line operators usually know more about the process on which they work than their managers do. Research has shown that participation and communication between local and central offices and between superiors and subordinates result in the transmission of critical information to which central management would otherwise not have access.

Education to Understand Information

The second critical element of empowering employees is to ensure that they understand the information they use and on which they are evaluated. Many executives believe that only managers need to understand the information generated by the MACS. Recently, it has become evident to many managers that employees at all levels must understand the organization's performance measures and the way they are computed in order to be able to take actions that lead to superior performance. For example, if employees do not understand how their actions affect a variable such as cycle time (the time it takes for a product or service to be produced or performed from start to finish), they will not know how to alter their actions to improve cycle time performance. If employees in a manufacturing plant are performing unnecessary actions on an assembly line or are idle, for example, the cycle time performance of their group will be affected. Similarly, at the point of service, or the point where organizational employees interact with customers, delays in the processing of claims also will increase cycle time.

Consider an airline whose intent is to improve its public image. From time to time, some airlines ask customers to fill out a customer satisfaction survey. If flight attendants have not been educated regarding how each of their actions (such as being rude or slow to produce service) directly affects customer satisfaction, the airline has failed to do its part to ensure satisfactory performance of one of its key indicators for flight attendants. This is also true in many other types of service organizations. In restaurants or department stores, customers often become frustrated with the level of service. For example, assigning waitpersons in a restaurant to too many tables can cause them to forget customer requests, or if they have annoying personal habits or are extremely clumsy, customers remember the negative experience and may not return. Consider a department store in which sales personnel may be too pushy, too difficult to find for service, or arrogant. A customer may become irritated with such an experience and vow never to shop at that store again.

Unless restaurant owners and department store managers educate their employees about how their actions affect customer perceptions of service quality and repeat business, the energy devoted to improving customer satisfaction is wasted. Studies have shown that, on average, five times as many customers who are dissatisfied with a product or service tell other people about their experience than do customers who are satisfied with a product or service. Thus, the reputation of organizations that offer a poorly produced product or a poorly delivered service can be ruined rather quickly. In general, poor or nonresponsive service by employees who have direct contact with

customers is usually evidence of poor management, poor training, and poor education rather than an indicator that the employee is not a good worker.

For MACS to function well, employees have to be constantly reeducated as the system and its performance measures change. Without continuous updating of everyone's education, companies cannot be leaders or even players in international markets. In the United States, lack of training is a severe problem. For example, some studies have shown that U.S. employees receive only one-tenth the training of Japanese employees. Thus, U.S. management cannot expect its employees to be globally competitive if management does not supply them with the necessary training. Ultimately, the concept of continuous education should become so ingrained in employees that continually mastering new skills becomes a job requirement. Organizations that foster such an environment have been labeled learning organizations.

BEHAVIORAL ASPECTS OF MACS DESIGN: AN EXAMPLE FROM BUDGETING

One area of MACS design that has been well studied from a behavioral point of view is the budgeting process. While we discuss the technical aspects of budgeting in Chapter 10, we highlight the behavioral issues in this chapter.

Most organizations use budgets as a financial representation of their strategy. The process of developing budgets is often a long one and can sometimes be contentious. Because of the human factor involved in the entire process, budgets often do not develop in a smooth, frictionless manner. How do people try to affect the budget and, in turn, how do budgets affect people's behavior? These questions have led social scientists to undertake extensive studies about the human factors involved in budgeting.

Whether developing a family budget, a budget for a small company, or a budget for a major multinational company, it is important to be aware that the ways in which people interact with budgets are essentially the same. This section presents two related behavioral issues in budgeting:

1. *Designing the budget process*—How should budgets be determined, who should be involved in the budgeting process, and at what level of difficulty should the budget be set to have the greatest positive influence on people's motivation and performance?
2. *Influencing the budget process*—How do people try to influence or manipulate the budget to their own ends?

Designing the Budget Process

Where do the data that planners use to prepare the master budget and supporting plans come from? How should budgets be determined, and who should be involved in the budgeting process? Three common methods of setting budgets are authoritative, participative, and consultative.

Authoritative Budgeting

Authoritative budgeting occurs when a superior informs subordinates what their budget will be without requesting input. The benefit to the organization is that the process is straightforward and efficient—it allows superiors to assign budgets and promotes overall coordination among subunits in the organization because it is done from a single perspective. Managers who want to impose a budget in a top-down manner often want control and have authoritarian aspects to their personalities.

One disadvantage of imposing budgets is that superiors usually have less information about the process being budgeted than the subordinate. In authoritative budgeting situations, the superior indicates the goals to the subordinates, and subordinates who have high aspirations for the coming year regarding new goals may become frustrated and debilitated. A second problem is the lack of motivation and commitment to the budgeted goals because of the lack of employee participation in establishing the budget. Worse yet, if the superior sets high goals and provides only a small budget for resource spending, motivation can decrease significantly, and individuals and the organization can fail to attain their goals.

Research shows that the most motivating types of budgets are those that are tight, that is, those with targets that are perceived as ambitious but attainable. Companies such as Boeing and General Electric have implemented what are known as *stretch targets*. In the past, both companies used an incremental approach in which targets from the previous year were increased slightly. Stretch targets exceed previous targets by a significant amount and usually require an enormous increase in a goal over the next budgeting period. Stretch budgeting means that the organization will try to reach much higher goals with the current budget. The rationale is that stretch targets push an organization to its limits. The thinking is that only in this manner will companies completely reevaluate the ways in which they develop and produce products and services. While some employees thrive in this type of environment, the pace of work and the difficulty of achieving stretch targets can frustrate many and cause others to quit their jobs. Further, whereas employees may be able to push themselves very hard to meet the stretch target in the short run, they may not be able to sustain a high level of effort in every subsequent period. Organizations need to make sure that they provide resources and a plan so that employees believe that stretch targets are achievable.

Participative Budgeting

Participative budgeting is an approach to budget setting that uses a joint decision-making process in which all parties agree about setting the budget targets. Allowing employees to participate in decision making provides an opportunity for them to use information that they develop through their training or experience on the job to jointly set their goals and negotiate the level of their budgets. Participation has many benefits for employees, such as greater feelings of commitment to the budget and, therefore, a higher level of motivation to attain goals and keep within the budget.

Research on participative budgeting has shown that employees who participate in the budgeting process generally feel greater job satisfaction and higher morale because they feel greater control over their jobs. In some instances, higher levels of performance can result. Allowing participation offers an additional benefit for management because it often induces subordinates to reveal their private information, reveals data about how well they can perform their jobs, or allows the introduction of new ideas that may help improve existing processes. As a result of discussing the budget jointly, subordinates indirectly reveal this information and their level of aspiration to management. It then can be incorporated into the planning process.

Consultative Budgeting

Consultative budgeting occurs when managers ask subordinates to discuss their ideas about the budget but no joint decision making occurs. Instead, the superior solicits the subordinates' ideas and determines the final budget alone. For many large organizations in which complete participation is impractical, consultation is the norm. A variant of the consultative form of budgeting may occur when subordinates believe their input will be used directly in setting the budget—even though their

superior really has no intention of considering their input. This process is called pseudoparticipation and can have a debilitating effect on subordinates if they find out that the superior was insincere.

Influencing the Budget Process

Clearly, the budgeting process is neither simple nor mechanical. It highlights the need for interactions about resource allocation, organizational goals, and human motivation and performance. In large organizations, as in families, budgets represent the outcomes of negotiations among individuals. Some individuals will do all they can to increase the size of their budgets because they believe a large budget is a symbol of power and control.

Although the budget is used as a tool for planning, coordinating, and resource allocation, it also serves to measure performance and serves ultimately to control and influence behavior. In addition, many managers have their incentive compensation tied directly to budget and goal attainment. When incentives and compensation are tied to the budget, some managers engage in behavior that is dysfunctional to their organizations. Managers have been known to play budgeting games in which they attempt to manipulate information and targets to achieve as high a bonus as possible. One well-known way that managers engage in budgeting games is through the participation process.

Participation has provided employees the opportunity to affect their budgets in ways that may not always be in the best interests of the organization. For example, subordinates might ask for more resources than they need to accomplish their budget objectives. This results in a misallocation of resources for the organization as a whole. Another risk is that subordinates will distort information by claiming that they are not as efficient or effective at what they do as they really are, thereby attempting to lower management's expectations of their performance. Subordinates may want some additional cushion in performance requirements in case there is an unforeseen change in the work environment that detrimentally affects resources or impairs their ability to meet the budget. If subordinates succeed in this type of negotiation, they will find it easy to meet or exceed their budgeted objectives. Again the organization suffers because it is not obtaining the most accurate information available to assess and thereby improve its operations. Both these acts—requiring excess resources and distorting performance information—fall under the heading of creating budget slack.

Consider a manager who is worried that a supplier will be unwilling to sell raw materials at a historically budgeted price. The manager may decide to increase the allowance requested for purchasing raw materials, which would build slack into this budget line item. The request leads to the assignment of excess resources for this purpose and, hence, fewer resources for other purposes. Other distortions can arise from arbitrary increases in resource requests because the resulting established standard costs for products will be incorrect. Further, subordinates are also concerned about standards or budgets that are too difficult to attain: If their bonuses are based on attaining a budget, they will opt for an easier budget. To counter the problem of low target setting, management may design an incentive system that provides higher levels of bonuses based on attaining higher targets.

Budgeting games can never be eliminated, although some organizations have devised methods to decrease the amount of budget slack. They can use an iterative process to formulate the budget, for example, developing a very lengthy budgeting cycle that may last as long as a year. Then subordinate managers submit a preliminary budget, which is modified by senior management and sent back to subordinate managers for modification. The modifications usually require justification in painful

detail for each line item. This process continues for several iterations until senior managers are convinced that they have eliminated as much slack as possible from the subordinate manager's budget. The other benefit of this approach is that by the time both parties agree to the budget, everyone has developed a strong commitment to it. This commitment gives everybody involved the confidence that they can achieve their goals for the coming year.

DEVELOPING APPROPRIATE INCENTIVE SYSTEMS TO REWARD PERFORMANCE

The final behavioral consideration in MACS design is to consider the most appropriate reward systems to further motivate employees. The following presentation begins with a focus on both intrinsic and extrinsic rewards and continues with a discussion of the many types of financial reward systems that organizations use. A number of different theories of human motivation exist, including expectancy theory, agency theory, and goal-setting theory. Each theory stresses different aspects of motivation. Because the debate regarding these theories is so extensive, readers must decide to which theory they subscribe.²

Organizations use both intrinsic and extrinsic rewards to motivate employees. **Intrinsic rewards** are those that come from within an individual and reflect satisfaction from doing the job and from the opportunities for growth that the job provides. In some cases, intrinsic rewards reflect the nature of the organization and type of work one is performing. For example, volunteering at a day care center offers no financial compensation but instead provides the volunteer with the feeling or reward that he or she is helping children learn. Even in jobs where people are financially compensated, one of management's most challenging tasks is to design jobs and develop



Rewards in organizations don't have to be monetary. In many cases getting recognition through trophies, certificates, and plaques can be highly motivating. Alamy Images Royalty Free

² Readers are referred to S. E. Bonner, and G. B. Sprinkle, "The Effects of Monetary Incentives on Effort and Task Performance: Theories, Evidence, and a Framework for Research," *Accounting, Organizations, and Society* (May/July 2002): 303–345.

an organizational environment and culture that lead employees to derive intrinsic rewards just by working. Organizations also hope that through the hiring process they can find a good match between a specific type of job and a specific individual. Because of how intrinsic rewards are derived, manufacturing accounting information has no effect on them.

Based on assessed performance, **extrinsic rewards** are any rewards that one person provides to another to recognize a job well done. Examples of commonly used extrinsic rewards are meals, tips, cash bonuses, stock bonuses, and recognition in newsletters and on plaques. Extrinsic rewards reinforce the notion that employees have distinguished themselves from the organization. Many people believe that extrinsic rewards also reinforce the common perception that the wage compensates the employee for a minimally acceptable effort and that the organization must use additional rewards or compensation to motivate the employee to provide additional effort.

Choosing between Intrinsic and Extrinsic Rewards

Many compensation experts believe that organizations have not made enough use of intrinsic rewards. They claim that, given proper management leadership, intrinsic rewards may have motivational effects as strong as or even stronger than extrinsic rewards. The issue of the effectiveness of intrinsic and extrinsic rewards is a topic of heated debate in the management literature. Some argue that people who expect to receive a reward for completing a task or for doing that task successfully do not perform as well as those who expect no reward at all. Others argue that, although this result holds true over a wide range of tasks, people, and rewards, the result is strongest when the job requires creative skills. For some, pay may not be a motivator. This argument is built around the idea that the preoccupation with extrinsic rewards undermines the effectiveness of reward systems and that the design of organizations and jobs should allow employees to experience intrinsic rewards.

The issue remains unresolved. However, one thing is clear: Most organizations have ignored and continue to ignore the role of intrinsic rewards in motivation and blindly accept the view that only financial extrinsic rewards motivate employees. Many people believe that financial extrinsic rewards are both necessary and sufficient to motivate superior performance. Both systematic and anecdotal evidence suggests, however, that financial extrinsic rewards are not necessary to create effective organizations and that performance rewards do not necessarily create them. Whether nonfinancial extrinsic and intrinsic rewards are more or less effective than financial extrinsic rewards in motivating behavior is an unresolved matter. However, both nonfinancial extrinsic and intrinsic rewards have a role to play in most organizations.

Beyond the debate about the relative effectiveness of intrinsic and extrinsic rewards, some people argue that incentive compensation programs in any form are unacceptable. They suggest that organizations must strive to be excellent to survive in a complex and competitive world. Thus, superior and committed performance is necessary for all employees in organizations and is part of the contract of employment, not something that merits additional pay.

Conversely, a large number of organizations rely on extrinsic monetary rewards to motivate performance. Since employees often engage in social comparisons of how they are performing at work, extrinsic monetary rewards are a tangible indicator of how well one is doing relative to others. These organizations base their reward systems to a large extent on information and measures provided by management accounting systems. The remainder of this section focuses on the kinds of extrinsic rewards that are most commonly used in organizations.

Extrinsic Rewards Based on Performance

Incentive compensation plans, or **pay-for-performance systems**, are reward systems that provide monetary (extrinsic) rewards based on measured results. Pay-for-performance systems base rewards on achieving or exceeding some measured performance. The underlying philosophy of this system is based on the adage “You get what you measure and reward.” Thus, organizations need performance measurement systems that gather relevant and reliable performance information. The reward can be based on absolute performance, performance relative to some plan, or performance relative to that of some comparable group. Measures of absolute performance include the following:

1. The number of acceptable quality units produced (such as a piece-rate system).
2. The organization’s results (such as profit levels or an organization’s Balanced Scorecard measures of customer or employee satisfaction, quality, and rate of successful new product introductions).
3. The organization’s share price performance (such as stock option plan).

Examples of rewards based on relative performance are those tied to the following:

1. The ability to exceed a performance target level (such as paying a manager for accomplishing his or her goals under budget or paying a production group a bonus for beating a benchmark performance level).
2. The amount of a bonus pool (such as sharing in a pool defined as the organization’s reported profits less a stipulated return to shareholders).
3. The degree to which performance exceeds the average performance level of a comparable group.

Occasionally, compensation policy can be affected by government regulations. For example, since 1994, for the purpose of computing taxable income, most organizations in the United States cannot claim as an expense the portion of any employee’s salary that exceeds \$1 million. This will certainly (1) reduce the use of salary and perquisites (such as company cars and club memberships) and (2) increase the use of variable pay based on performance.

Effective Performance Measurement and Reward Systems

The following six attributes of a measurement system must be in place in order to motivate desired performance:

1. **The employees must understand their jobs and the reward system and believe that it measures what they control and contribute to the organization.** This attribute ensures that the employee perceives the reward system as fair and predictable. If employees do not understand their jobs or how to improve their measured performance, a reward system based on performance measures is ineffective. In this case, employees perceive no relationship between effort and performance and, ultimately, outcomes. Similarly, if the reward system is complex, employees are unable to relate perceived performance improvements to changes in outcomes, and the motivational effect of the reward system will be lost. Additionally, if the reward system does not measure employees’ controllable performance, they conclude that measured performance is independent of their efforts, and again the incentive effect of the reward system is lost. Specifying and developing a clear relationship among effort, performance, and results and ensuring that all employees understand this relationship is a critical management role. Therefore, the centerpiece of incentive compensation systems is the performance measurement system, which becomes the focus of the employees’ attention. The

decisions that employees make in pursuing the performance measures that ultimately provide valued personal outcomes move the organization toward achieving its goals if the performance measures are aligned with the organization's goals.

2. Related to the first attribute, designers of the performance measurement system must make a careful choice about whether it measures employees' inputs or outputs. In general, the greatest alignment between employees' and the organization's interests is provided when the performance measurement system monitors and rewards employee outputs that contribute to the organization's success. However, outputs often reflect circumstances and conditions that are beyond the employee's control, and when they do, the perceived link between individuals' efforts and measured results is reduced, thereby decreasing the motivation provided by the reward system. Under circumstances when outcome measurement is problematic, organizations often choose to monitor and reward inputs (such as employee learning, demonstrated skill, and time worked). For example, in some manufacturing organizations, employees can take on-site night classes to increase their skills. Once these classes are completed and the new skills mastered, the employees are moved to a higher wage level. The choice of the mix of performance measures and the decision about whether those measures are input based, output based, or a combination of measures make up one of the most difficult tasks in the design of performance measurement and compensation systems.

3. The elements of performance that the performance measurement system monitors and rewards should reflect the organization's critical success factors. This attribute ensures that the performance system is relevant and motivates intended performance that matters to the organization's success. Moreover, the performance measurement system must consider all facets of performance so that employees do not sacrifice performance on an unmeasured element for performance on an element that the reward system measures. This is the role and purpose of measuring and rewarding employees across a set of balanced and comprehensive measures, as proposed in the Balanced Scorecard. For example, if a supervisor tells a telephone operator that productivity (such as the number of help requests handled per shift) is important, the operator may sacrifice the quality and courtesy offered to customers in order to handle as many questions as possible.

4. The reward system must set clear standards for performance that employees accept. Standards help employees assess whether their skills and efforts create results that the performance measurement system captures and reports as outcomes. This attribute determines employees' beliefs about whether the performance system is fair. If performance standards are either unspecified or unclear to employees, the relationship between performance and outcome is ambiguous and thereby reduces the motivational effect of the performance reward system.

5. The measurement system must be calibrated so that it can accurately assess performance. This attribute ensures that the performance measurement system establishes a clear relationship between performance and outcome.

6. When it is critical that employees coordinate decision making and other activities with other employees, the reward system should reward group rather than individual performance. Many organizations now believe that, to be effective, employees must work well in teams. These organizations are replacing evaluations and rewards based on individual performance with rewards and evaluations based on group performance.

In most organizations, pay is more than simply what is required to keep an employee from leaving the organization. Pay is part of the complex bundle of factors that motivate people to work in the organization's best interests. Therefore, organizations must consider pay issues within the larger context of motivation.

Conditions Favoring Incentive Compensation

Not all organizations are suited to incentive compensation systems. Centralized organizations require most of the important operating decisions to be made in the head office. Such organizations are unsuited to incentive compensation systems for their front-line employees because employees in these organizations are expected to follow rules and have no authority to make decisions. In fact, it is more appropriate to call compensation systems in these organizations enforcement systems because employment continues only if people follow the rules and standard operating procedures. Here the task of the management accountant is to design internal control systems and conduct internal audits to verify that people are following rules and procedures.

Incentive compensation systems work best in organizations in which employees have the skill and authority to react to conditions and make decisions. We previously discussed organizations that face continually changing environments—ones in which it is either impractical or impossible to develop standard operating procedures to deal with these changing conditions. Such organizations can develop incentive compensation systems that motivate employees to identify changes in the environment, to apply their skills and knowledge accordingly, and to make decisions that best reflect the organization's goals.

When the organization has empowered its employees to make decisions, it can use incentive compensation systems to motivate appropriate decision-making behavior. In these organizations, the focus of control changes from telling people what to do to asking employees to use their skills and delegated authority to do their best to help the organization achieve its stated objectives.

Incentive Compensation and Employee Responsibility

The incentive compensation system must focus primarily on outcomes that the employee controls or influences. Consider an incentive compensation plan that rewards the performance of a production worker only when the sales department meets its sales target. Assuming that the worker is responsible only for the amount of resources used in the production of a product and its quality, it would be demotivating to base the employee's compensation on a sales target because the sales department, and not the production department, controls the level of sales.

Employees' incentive compensation should reflect the nature of their responsibilities in the organization. Employees whose roles are to plan, coordinate, and control day-to-day activities should receive rewards based on their ability to manage these daily operations effectively and to make the best short-term use of available resources. Their rewards should be tied to short-term controllable performance measures, such as efficiency and the ability to meet customer quality and service requirements. Employees whose roles are to plan long-term projects, such as building new facilities or acquiring significant capital equipment, should be rewarded on the basis of the long-term growth or improvement in the organization's operations that results from their strategic choices. These rewards should be based on the organization's performance compared with its stated objectives. In some cases, rewards also can be based on how an organization's performance compares with that of other, similar organizations. This mix of rewarding both short- and long-term outcomes is consistent with the goals of the Balanced Scorecard approach discussed in Chapter 2.

Rewarding Outcomes

Another consideration in the design of effective incentive compensation systems is the manner in which performance is measured. Incentive compensation schemes tie

rewards to the outputs of employee performance rather than to such inputs as their level of effort. Moreover, incentive compensation based on outcomes requires that organization members understand and contribute to the organization's objectives.

However, rewards can be based on inputs in three instances:

- When it is impossible to measure outcomes consistently.
- When outcomes are affected by factors beyond the employee's control.
- When outcomes are expensive to measure.

Input-based compensation measures the time, knowledge, and skill level that the employee brings to the job, with the expectation that the unmeasured outcome is correlated with these inputs. Many organizations use some form of knowledge-based remuneration. This type of remuneration bases the rate of pay on an employee's training and job qualifications, which can be upgraded by on-the-job training. The employee's compensation is the product of the number of hours worked (time input) and the hourly rate (a reflection of the deemed level of skill input). Organizations use knowledge-based pay to motivate employees to continuously upgrade their job skills, thereby allowing them to receive a higher base pay.

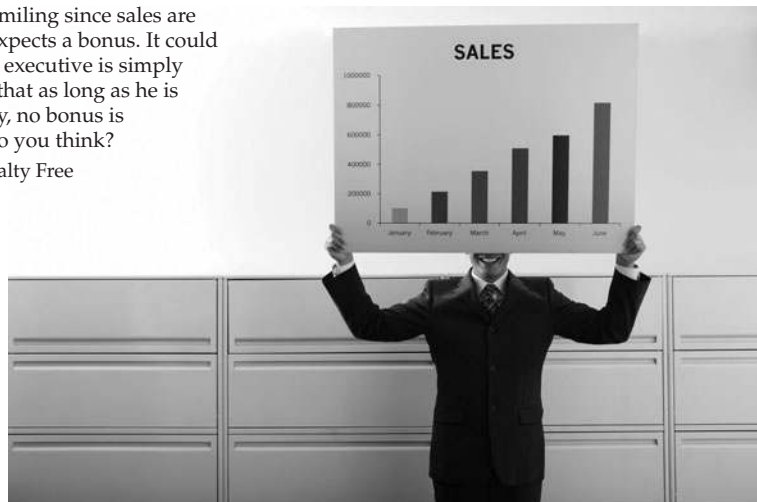
Managing Incentive Compensation Plans

Considerable evidence indicates that organizations have mismanaged incentive compensation plans, particularly those for senior executives. Many articles have appeared in influential business periodicals arguing that executives, particularly executives of U.S. corporations, have been paid excessively for mediocre performance.

Experts debate whether compensation systems motivate goal-seeking behavior and whether they are efficient, that is, whether they pay what is needed and no more. Some studies show a positive correlation between executive compensation and shareholder wealth. Other studies report finding no correlation (or even a negative one) between organization performance and executive compensation. Until recently, shareholder value was decreasing, while executive compensation was climbing. Some believe it is particularly inappropriate for companies to continue operating compensation systems in which executive rewards bear no relation to corporate performance.

This executive is smiling since sales are going up and he expects a bonus. It could be argued that the executive is simply doing his job and that as long as he is compensated fairly, no bonus is necessary. What do you think?

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Despite economic data showing an association between executive compensation and company performance, many professionals still argue that the amounts are excessive and reflect high status rather than good performance. The issue of fairness has also surfaced. Surveys indicate that, on average, chief executive officers in the United States earn 300 times the amount of the lowest paid employee. In Japan, however, the relationship is only 30 times the lowest paid worker. That these questions are raised reflects perceptions of unfairness and a degree of cynicism that average people feel about the role of incentive compensation in organizations.

Types of Incentive Compensation Plans

The most common incentive compensation plans are cash bonuses, profit sharing, gain sharing, stock options, performance shares stock, stock appreciation rights, participation units, and employee stock ownership plans. These different plans pose varying challenges for the management accounting system.

We can group compensation plans into two broad categories: (1) those that rely on internal measures, invariably provided by the organization's management accounting system, and (2) those that rely on performance of the organization's share price in the stock market.

Management accountants get involved in the first group of plans—those that revolve around rewards based on performance that the organization's management accounting system monitors and reports. Most employees who participate in financial incentive plans take the plans very seriously. These people are both interested in and concerned about the performance measurement system that monitors and reports the performance measures used to compute and distribute financial rewards. Many practicing management accountants have found that the most contentious debates arise from issues relating to performance measurement used for financial rewards. Therefore, management accountants take the matter of developing performance measures for financial reward systems very seriously.

Organizations use many other forms of stock-related incentive compensation plans, including performance shares stock, stock appreciation rights, participation units, and employee stock ownership plans that are beyond the scope of issues in management accounting. These plans provide incentive compensation to the participants when the stock price increases. The idea behind such plans is to motivate employees to act in the long-term interests of the organization by engaging in activities that increase the organization's market value. Therefore, all of these plans assume that stock markets will recognize exceptional behavior in the form of increased stock prices.

Cash Bonus

A **cash bonus** plan—also called a lump-sum reward, pay for performance, or merit pay—pays cash on the basis of some measured performance. Such a bonus is a one-time award that does not become part of the employee's base pay in subsequent years.

Cash bonuses can be fixed in amount and triggered when measured performance exceeds the target, or they can be proportional to the level of performance relative to the target. They can be based on individual or group performance, and they can be paid to individuals or groups.

For example, in the late 1980s, General Motors eliminated automatic salary increases based on increases in the cost of living and replaced them with a pay-for-performance system that rewarded managers based on their results. Managers were required to group their employees into four groups: high performers (the top 10%), good performers (the next 25%), average performers (the next 55%), and low

performers (the last 10%). Supervisors used these groupings to award merit pay and to enforce salary differences based on assessed performance.

Profit Sharing

Profit sharing is a cash bonus calculated as a percentage of an organization's reported profit. Profit sharing is a group incentive compensation plan focused on short-term performance.

All profit-sharing plans define what portion of the organization's reported profits is available for sharing, the sharing formula, the employees who are eligible to participate in the plan, and the formula for each employee's share.

Many profit-sharing plans are based on residual income, now called economic value added. In such plans, the reported profit will be reduced by some percentage (say, 15%) of the shareholders' investment in the organization. This allotment provides the shareholders with the required return on their investment. The resulting pool is shared between employees and shareholders on some fractional basis, such as 40% for employees and 60% for shareholders. The plan also may specify a limit on the total amount of profits that can be distributed to employees. In addition, the profit-sharing plan specifies how it will distribute the money in the pool to each employee: Some plans provide equal distribution; others distribute the bonus pool on the basis of the employee's performance relative to individual performance targets.

IN PRACTICE

UNIBANCO—Tying the Balanced Scorecard to Compensation

Unibanco, with more than US \$23 billion in total assets, is the fifth largest bank in Brazil, and the third largest in the private sector. Unibanco started its Balanced Scorecard project in 2000 by building a company scorecard and scorecards for its four major business units: insurance and pension, retail, wholesale, and asset (wealth) management. During 2001, senior executives launched a communication campaign to inform all 27,000 employees about the new strategy and the method for managing the strategy. It used the Schürmann family of Brazil, famous for traveling the world in a sailboat, to give talks to 2,000 managers at various bank locations on how "we're all in the same boat," and that each crew member has to know the destination for them to contribute to the objective of the boat reaching its destination successfully. Advertisements and articles about the Painel de Gestão (management panel) and the relevant indicators appeared on the corporate intranet portal and the internal TV network, in the internal monthly magazine, and in personal e-mails sent to every manager. The successful sailing campaign branded the scorecard concept for employees and made everyone aware that their everyday actions affected the success of the company strategy. Several years later, in 2004, Unibanco launched a 2-10-20 campaign: the goals were to achieve by the 80th anniversary year in 2006, R2 billion in income, R10 billion

in equity, and a 20% return-on-equity. The communications program promoted the 2-10-20 slogan everywhere, including in elevator displays.

People were encouraged to tell the story of how their actions led to successful outcomes. Each monthly issue of the internal magazine selected the best stories to celebrate the individuals and teams that had achieved significant results on key performance indicators. Annually, Unibanco provided a presidential reward for initiatives that achieved breakthrough results for a strategic theme.

In 2002, Unibanco adapted an existing personnel management tool, the management agreement between each employee and his or her manager. The first page of the revised management agreement described the unit's and the bank's strategic themes. Employees then created their personal management agreement, with their supervisors, aligned to the unit and bank's strategic themes. The management agreement had employee objectives in the four BSC perspectives that were clearly linked to one or more unit and corporate strategic themes. For example, an employee in the marketing department, helping to create a campaign to stimulate new accounts, would have a financial objective related to the estimated lifetime value of new accounts acquired. An employee producing an output used by another bank unit would treat the

(continued)

value delivered to the other unit as a customer objective. Unibanco used the management agreement in every employee's recognition and bonus plan. For the learning and growth objective in the management agreement, the human resources group helped employees determine the competencies—knowledge, skills, and behavior—they required to reach the objectives in their three other management agreement perspectives.

Unibanco's previous compensation program assigned a total compensation pool to each unit based on the unit's financial performance. The bank modified this program by adding two additional elements of variable pay. First, it added (or subtracted) a percentage

to the compensation pool based on the lead (nonfinancial) indicators on the unit's Balanced Scorecard; another percentage was added or subtracted based on the company's performance. The company included a corporate bonus component so that employees would think about the total bank's performance, not just the performance of their decentralized unit.

From 1999 to 2004, Unibanco's employee "comprehension of the company's mission and vision" rose from 72% to 83%. Earnings per share increased from 5.57 in 1999 to 9.45 in 2004, with expectations of continued substantial increases in future years (to reach the 2-10-20 targets).

Source: R. Kaplan and D. Norton, *The Execution Premium: Linking Strategy to Operations for Competitive Advantage* (Boston: Harvard Business School Press, 2008).

In the performance compensation approach, employees receive a performance score that reflects how well they achieved specific performance goals for that year. The employee's score divided by the total scores of all employees in the profit-sharing agreement is the individual's share of the pool total. Some profit-sharing plans distribute rewards to each employee in an amount proportional to the base wage or salary because the plans' designers believe this reflects the employee's contribution to the overall result.

Profit-sharing plans require a number of contributions from the organization's accounting systems in general and from the management accounting system in particular. First, the organization must prepare a means to calculate profits. This process usually is monitored and attested to by an external auditor. Second, when a deduction is to be made from the pool that is based on the owners' investment, the management accounting system must provide a measure of invested capital. Third, when the profit sharing is based on some measured level of performance (for example, a composite score that reflects the employee's ability to meet a set of performance targets), the management accounting system must provide the underlying measures of performance and the overall performance score.

Gain Sharing

Gain sharing is a system for distributing cash bonuses from a pool when the total amount available is a function of performance relative to some target. For example, employees in a designated unit receive bonuses when their performance exceeds a performance target. Gain sharing is a group incentive, unlike the pay-for-performance cash bonus, which is an individual reward. In its usual form, gain sharing provides for the sharing of financial gains in organizational performance. The gain-sharing plan usually applies to a group of employees within an organization unit, such as a department or a store. It uses a formula to specify the amount and distribution of the rewards and a base period of performance as the benchmark for comparing subsequent performance. This benchmark is not changed unless a major change occurs in process or technology. When performance exceeds the base period performance, the gain-sharing plan pays a bonus pool.

Gain sharing promotes teamwork and participation in decision making. It requires employees to have the skills to participate and the organization to encourage participation. Consider these companies that have used gain sharing effectively:

- The Herman Miller Company, a furniture manufacturer that is frequently rated as one of the 10 best managed U.S. corporations, has used a gain-sharing plan

for many years. The company also uses a strategy of employee involvement that supports and enhances the motivational effect of the gain-sharing plan.

- Grumman Corporation developed a performance bonus plan for the crew in its Long Life Vehicle project that it used in conjunction with its Grumman quality program. Employees focused on processes that involved rework, scrap, and excessive maintenance costs. Half the savings from improved performance were divided equally among the crew members working on the project.

The three most widely used gain-sharing programs are improshare, the Scanlon plan, and the Rucker plan:

1. **Improshare** (improved productivity sharing) determines its bonus pool by computing the difference between the target level of labor cost given the level of production and the actual labor cost (the direct labor efficiency variance; see Chapter 10 for details). The plan specifies how the difference will be shared between the shareholders and the employees and how to calculate the amount distributed to each employee.
2. The **Scanlon plan** is based on the following formula, computed using the data in some base period:

$$\text{Base ratio} = \text{Payroll costs} / \text{Value of goods or services produced}$$

For example, if in the base period payroll costs are \$25 million and the deemed value of production or service is \$86 million, the base ratio would be 0.29 (\$25 million ÷ \$86 million). In any period in which the ratio of labor costs to the value of production or service is less than the base ratio, the deemed labor savings are added to a bonus pool. Therefore, continuing the previous example, if actual payroll costs were \$28 million in a period when the deemed value of production was \$105 million, the amount added to the bonus pool would be as follows:

$$\begin{aligned} \text{Amount added to bonus pool} &= (\text{Value of production this period} \times \text{Base ratio}) \\ &\quad - \text{Actual payroll costs} \\ &= (\$105,000,000 \times 0.29) - \$28,000,000 \\ &= \$2,450,000 \end{aligned}$$

When labor costs are more than the base ratio, some organizations deduct the difference from the bonus pool. Periodically, usually once a year, the pool is apportioned between the company and the employees in the pool using the plant ratio, which is often 50%/50%.

3. The **Rucker plan** is based on the following formula, which reflects the data from a representative period:

$$\text{Rucker standard} = \text{Payroll costs} / \text{Production value}$$

where production value is measured as Net sales – Inventory change – Materials and supplies used. As in the Scanlon plan, the idea of the Rucker plan is to define a baseline relationship between payroll costs and the value of production and then to reward workers who improve efficiency. Efficiency is measured as lowering the ratio of payroll costs to the value of production. When actual costs are less than the Rucker standard, the employees receive a bonus.

For gain-sharing plans to work, they must reflect performance levels that are reasonable. As might be expected, management and the employees who are subject to these plans often have very different ideas about what is fair. Management usually seeks tighter standards or targets, and employees want the opposite. These plans require that management, the management accountant, and employees participate in seeking the performance level that will serve as the standards or benchmarks for the

plans. Many management accountants relish their role as the honest brokers between management and the employees who are subject to these plans.

The people who designed gain-sharing plans believed, from the beginning, that monthly or even weekly performance awards are best because they provide rapid feedback and, therefore, additional motivation, because rewards reinforce the desired type of behavior. However, although rapid feedback may improve the motivational effect of rewards (expectancy), short-cycle feedback can put strains on the organization's management accounting system when the need for recording and accruing labor costs increases both the cost and potential for error in the management accounting system.

Since gain-sharing plans are team-based rewards, they have the associated problem that some team members may not be doing their fair share and could earn rewards based on the work of others. For example, students often complain about group projects, particularly when they cannot choose their own groups, because someone in the group often refuses to do or is incapable of doing the work. Students, like employees, are often uncomfortable about disciplining, or reporting, their peers. The early proponents of gain sharing recognized this phenomenon and observed that for gain sharing to work, the organizational culture must promote cohesive relationships within the group and between the group and management.

In addition, corporate culture has a significant effect on the potential of gain-sharing plans. These programs rely on employee commitment and involvement. Therefore, a corporate culture that respects employees, encourages their involvement, and actively supports employee learning and innovation reinforces the motivational potential of a gain-sharing program.

Like all incentive programs, gain-sharing programs work best when they are simple to understand and monitor. A test of this attribute is whether employees can do the math to compute their own bonuses. In addition, such programs should be perceived as fair, as being directly affected by employee performance, and as being conducive to promoting teamwork.

Gain-sharing plans usually rely on performance measures reported by an organization's management accounting system, which plays a primary supporting role in the gain-sharing process. Most gain-sharing plans focus on management accounting measures relating to labor costs and the relationship of actual labor cost to some standard, or budgeted, level of labor cost. Therefore, the key issues in performance measurement relate to measuring labor costs accurately and consistently and to having the ability to establish a cost standard that is perceived as fair.

Stock Options and Other Stock-Related Compensation Plans

Judging by the published remarks of compensation experts, **stock options** are the most widely known, misused, and maligned approach to incentive compensation. A stock option is the right to purchase a unit of an organization's stock at a specified price, called the option price.

A common approach to option pricing is to set the option price at about 105% of the stock's market price at the time the organization issues the stock option. This method is intended to motivate the employee who has been granted the stock option to act in the long-term interests of the organization, thereby increasing the value of the firm so that the market price of the stock will exceed the option price. For this reason, compensation system designers usually restrict stock options to senior executives because they believe that these people have the greatest effect on increasing the market value of the organization. Others have argued, however, that operations staff, as they carry out short-term operating plans, can make significant and sustainable process improvements. This would provide the organization with a competitive advantage, thereby increasing the organization's market value.

The critics of stock option plans have argued that organizations have been too generous in rewarding senior executives with stock options. For example, the organization may issue a senior executive many thousands of stock options with an option price that is very near (or even below) the market price at the time the stock option is issued. This is an implementation issue, not a fundamental defect of stock options. Some critics have argued, however, that stock price increases often reflect general market trends that have nothing to do with the performance of the individual organization. For this reason, many incentive compensation experts have argued that the stock option price should be keyed to the performance of the organization's shares relative to the performance of the prices of comparable shares. In this case, the stock option would be valuable only if the organization's share price increases more rapidly than the share prices of comparable organizations. Since management accountants are often involved in studies or systems that rely on external benchmarks, organizations sometimes delegate the role of developing the appropriate performance standards for relative stock option plans to a team that includes a management accountant.

In general, the use of employee stock ownership plans assumes that employees will work harder when they have an ownership stake. Avis, the automobile rental company, used an employee stock ownership plan to improve employee motivation, resulting in both higher sales and a higher margin on sales. Salomon Brothers, a Wall Street investment house, provided huge bonuses for high-performing employees during the 1980s and early 1990s. For example, one bond trader was paid a \$23 million bonus in 1990. Reacting to this, Salomon Brothers' largest shareholder, Warren Buffett, whom *Forbes* magazine identified as the wealthiest person in the United States in 1993 and who was interim chairman at the time, indicated that he wanted Salomon Brothers employees to earn rewards through owning shares, not by free riding on the owners' investment. To align the interests of the firm's employees and its shareholders and provide for more reasonable performance rewards, Buffett, through the Salomon Brothers Compensation Committee, developed an incentive plan that paid employees up to half their pay in company stock, issued at below-market prices, but that could not be sold for at least five years after issue. However, Buffett failed to weigh a consideration that is vital in designing any compensation plan, namely, how other investment banking firms were compensating their employees. While some people applauded the rationality of Buffett's plan, many employees left the firm to join other investment banking firms that were using compensation practices similar to the ones abandoned at Salomon Brothers. These departures precipitated a crisis that eventually led to the scrapping of the new plan.

EPILOGUE TO ADVANCED CELLULAR INTERNATIONAL AND CHAPTER SUMMARY

In the opening vignette to this chapter, Wayne Jagielski thought he had not been careful enough to involve employees in designing his new MACS. He wondered whether there were other behavioral considerations that he needed to take into account and manage. This chapter outlined four key behavioral characteristics that make up a well-designed MACS. The choice of the four characteristics is based largely on an acceptance of the human resources model of human motivation. Understanding these characteristics should provide Wayne guidance for designing his new MACS.

The first is embedding the organization's ethical code of conduct into MACS design. At the core of a well-designed MACS is the organization's ethical code of conduct. Ethical codes of conduct help organizations deal with ethical dilemmas or conflicts between individuals and organizational values and those that exist between the organization's stated and practiced values. The elements of an effective ethical control system were presented together with a specific decision model that can be applied when attempting to resolve ethical issues.

Organizations spend a lot of time determining how to motivate employees. One way is to align the goals of employees with those of the organization. However, even if goals are aligned, organizations cannot always rely on employee self-control to achieve targeted performance. In many instances, organizations must set up task or results control systems. Task control uses either preventive control devices or relies on monitoring, whereas results control focuses on comparing actual results to desired performance. Development and use of the right kinds of performance measures are tied directly into the second behavioral characteristic, which involves using a mix of short- and long-term qualitative and quantitative performance measures. This is the Balanced Scorecard approach. Even in the best control systems, employees often attempt to engage in non-goal-congruent behavior and we illustrated this within a budgeting context. One of the most challenging aspects of control system design is to find ways to mitigate these problems.

The third characteristic is empowering employees to be involved in decision making and MACS design. This characteristic acknowledges that people are the organization's greatest asset. Providing a voice through participation has a twofold benefit. First, participation in decision making has been shown to increase employee morale, commitment to a decision, and job satisfaction. Second, by allowing employees to participate, the organization is able to gather information about jobs and processes from the individuals who are closest to those jobs and processes. Such information provides managers with insights that they would not normally be able to obtain simply by performing cursory inspections of how people are working. Continuing to educate employees in the information they are using and

being evaluated on is another critical aspect of employee involvement. For example, without a clear understanding of how their actions translate into a score on a performance measure, employees are left without direction and may take actions detrimental to the organization.

Both intrinsic and extrinsic rewards are used by organizations to motivate employees. However, intrinsic rewards come from inside an individual and may simply be the result of an employee liking a specific job. Organizations try to hire individuals who will match a particular job and thus be intrinsically motivated. However, even if intrinsic motivation exists, many organizations still rely on extrinsic rewards, such as financial incentives, for motivational purposes.

Developing an appropriate incentive system to reward performance is the fourth characteristic. This chapter discussed the characteristics of an effective performance measurement system and the most common ways of rewarding results, including cash bonus, gain sharing, and stock options.

Finally, this chapter provided examples of behavioral and organizational issues that arise in relation to budgets, an important part of management and control systems. Because budgets are developed and implemented through people, we must consider the effects that budgets and budgeting have on people and how people affect budgets and budgeting. Research suggests that involving those subject to budgets in the budgeting process increases their commitment to the budget if people believe that they are contributing to the setting of targets and standards. In this regard, research also suggests that stretch targets, which are targets deemed difficult but achievable by the people subject to the target, are the most effective in motivating performance levels.

KEY TERMS

authoritative budgeting, 357	goal congruence, 350	pay-for-performance systems, 362
cash bonus, 366	human relations movement, 344	preventive control, 351
consultative budgeting, 358	human resources model	profit sharing, 367
data falsification, 354	of motivation (HRMM), 344	results control, 352
diagnostic control systems, 350	improshare, 369	Rucker plan, 369
dysfunctional behavior, 353	incentive compensation, 362	Scanlon plan, 369
earnings management, 354	interactive control systems, 350	scientific management school, 344
employee self-control, 350	intrinsic rewards, 360	smoothing, 354
ethical control system, 349	management accounting	stock option, 370
extrinsic rewards, 361	and control system (MACS), 342	task control, 351
gain sharing, 368	monitoring, 351	
gaming the performance	motivation, 344	
indicator, 353	participative budgeting, 358	

ASSIGNMENT MATERIALS

Questions

- 9-1 What does *control* refer to in the context of a management accounting and control system? (LO 1)
- 9-2 What are the four stages involved in keeping an organization in control? (LO 1)
- 9-3 What two broad technical considerations must designers of management and control systems address? (LO 2)
- 9-4 What four components should MACS designers consider when addressing the relevance of the system's information? (LO 2)
- 9-5 What are the four major behavioral considerations in MACS design? (LO 3)
- 9-6 What is the scientific management view of motivation? (LO 4)
- 9-7 What is the human relations movement view of motivation? (LO 4)
- 9-8 What is the human resources model view of motivation? (LO 4)
- 9-9 What are some choices that individuals can make when ethical conflicts arise? (LO 5)
- 9-10 What is an ethical control system, and what are its key elements? (LO 5)
- 9-11 What are the three key dimensions of motivation? (LO 6)
- 9-12 What is goal congruence? (LO 6)
- 9-13 How do diagnostic control systems differ from interactive control systems? (LO 6)
- 9-14 How does task control differ from results control? (LO 6, 7)
- 9-15 List and explain the two categories in task control. (LO 6, 7)
- 9-16 List three quantitative financial measures of performance in a manufacturing organization of your choice. (LO 8)
- 9-17 List three quantitative financial measures of performance in a service organization of your choice. (LO 8)
- 9-18 List three quantitative nonfinancial measures of performance in a manufacturing organization of your choice. (LO 8)
- 9-19 List three quantitative nonfinancial measures of performance in a service organization of your choice. (LO 8)
- 9-20 List three qualitative measures of performance. (LO 8)
- 9-21 What is meant by *gaming a performance indicator*? (LO 6, 8)
- 9-22 What is data falsification? (LO 6, 8)
- 9-23 What is the single most important factor in making major changes to an organization? (LO 6, 8)
- 9-24 What is an example of earnings management or smoothing? (LO 6, 8)
- 9-25 What are two essential elements in employee empowerment in MACS design? (LO 9)
- 9-26 What are the two interrelated behavioral issues in budgeting? (LO 10)
- 9-27 What are the three most common methods of setting a budget? (LO 10)
- 9-28 What is the most motivating type of budget with respect to targets? (LO 10)
- 9-29 What is a stretch target? (LO 10)
- 9-30 What is budget slack? (LO 10)
- 9-31 What is an intrinsic reward? (LO 11)
- 9-32 What is an extrinsic reward? (LO 11)
- 9-33 What is incentive compensation? (LO 11)
- 9-34 What are the six attributes of effective performance measurement systems? (LO 11)
- 9-35 What type of organization is best suited to incentive compensation? Why? (LO 11)
- 9-36 What is a cash bonus? (LO 11)
- 9-37 What is profit sharing? (LO 11)
- 9-38 What is gain sharing? (LO 11)
- 9-39 What is a stock option plan? (LO 11)

Exercises

- LO 1 9-40 *Achieving objectives* Eni Corporation's mission statement includes the following: "Our mission is to continuously improve the company's value to shareholders, customers, employees, and society." Interpret how each of Eni Corporation's stakeholder groups may interpret "the company's value" in the mission statement and, given each group's interpretation, how it may be measured for each group.
- LO 2 9-41 *Achieving relevance in MACS design* Identify the four components that MACS designers should consider when addressing the relevance of the system's information and explain why each component is important.

- LO 4** 9-42 *Managerial approaches to motivation* How do the scientific management, human relations, and human resource schools differ in their views on human motivation?
- LO 5** 9-43 *Characteristics of a MACS: ethical framework* List and describe the hierarchy of ethical considerations.
- LO 5** 9-44 *Ethical conflicts* What should a person do if faced with a conflict between his or her values and those of the organization?
- LO 5** 9-45 *Ethical conflicts* What should a person do if the organization's stated values conflict with practiced values? What are the individual's choices? Why do you think such conflicts exist?
- LO 6, 7** 9-46 *Choosing an approach to control* Think of any setting in need of control. Explain why you think that task control or results control would be more appropriate in the setting that you have chosen. Do not use an example from the text.
- LO 6, 8** 9-47 *Characteristics of a MACS: multiple performance measures* What is the advantage of having multiple measures of performance?
- LO 6, 11** 9-48 *Understanding performance measurement* Why is it important that people understand what performance is measured, how performance is measured, and how employee rewards relate to measured performance?
- LO 6** 9-49 *Controllable performance* Why should performance measurement systems and rewards focus on performance that employees can control?
- LO 6, 7** 9-50 *Tailoring performance measurement to the job* In a company that takes telephone orders from customers for general merchandise, explain how you would evaluate the performance of the company president, a middle manager who designs the system to coordinate order taking and order shipping, and an employee who fills orders. How are the performance measurement systems similar? How are the performance measurement systems different?
- LO 6, 11** 9-51 *Characteristics of a MACS: rewards* Can goal congruence be increased if rewards are tied to performance? Explain.
- LO 6** 9-52 *Non-goal-congruent behavior* What distinguishes data falsification from gaming activities?
- LO 6** 9-53 *Non-goal-congruent behavior* List some methods of gaming performance indicators.
- LO 6** 9-54 *Non-goal-congruent behavior* Can you think of instances when gaming behavior is appropriate in an organization?
- LO 4, 9** 9-55 *Characteristics of a MACS: participation* What are the advantages for the individual in being able to participate in decision making in the organization, and what are the advantages for the organization in allowing the individual to participate in decision making?
- LO 10** 9-56 *Method of designing the budget* How does participation in the budgeting process differ from consultation?
- LO 10** 9-57 *Budget slack* What are the pros and cons of building slack into the budget from (1) the point of view of the employee building in slack and (2) from a senior manager's point of view?
- LO 10** 9-58 *Budgeting games* What are budgeting games, and why do employees engage in them?
- LO 11** 9-59 *The nature of intrinsic and extrinsic rewards* Do you believe that people value intrinsic rewards? Give an example of an intrinsic reward that you would value and explain why. Why are extrinsic rewards important to people? If you value only extrinsic rewards, explain why.
- LO 11** 9-60 *Choosing what to reward* Explain when one would reward outcomes or outputs, reward inputs, or use knowledge-based pay.

- LO 11 9-61 *Choosing the reward level* You work for a consulting firm and have been given the assignment of deciding whether a particular company president is overpaid both in absolute terms and relative to presidents of comparable companies. How would you undertake this task?
- LO 11 9-62 *Using cash bonuses* When should an organization use a cash bonus?
- LO 11 9-63 *Using profit sharing* When should an organization use profit sharing?
- LO 11 9-64 *Using gain sharing* When should an organization use gain sharing?
- LO 11 9-65 *Using stock options* When should an organization use stock options?
- LO 11 9-66 *Rewarding group performance* How would you reward a group of people that includes product designers, engineers, production personnel, purchasing agents, marketing staff, and accountants whose job is to identify and develop a new car? How would you reward a person whose job is to discover a better way of designing crash protection devices in cars? How are these two situations similar? How are they different?

Problems

- LO 3, 4 9-67 *MACS design motivation* Explain why an understanding of human motivation is essential to MACS design.
- LO 3 9-68 *Behavioral considerations in MACS design* List the four key behavioral considerations in MACS design and explain the importance or benefits of each.
- LO 5 9-69 *Relationship between ethics in golf and business* Refer to “Does Cheating at Golf Lead to Cheating in Business?” in the In Practice box on page 347. Discuss reasons why individuals might feel justified in cheating at golf and whether individuals who cheat at golf are likely also to cheat in business.
- LO 5 9-70 *Ethical issues* Suppose you are the chief executive officer of a manufacturing firm that is bidding on a government contract. In this situation, the firm with the lowest bid will win the contract. Your firm has completed developing its bid and is ready to submit it to the government when you receive an anonymously sent packet containing a competitor’s bid that is lower than yours. If your firm loses the bid, you may need to lay off some employees, and your profits will suffer. What are some possible options in this situation, what are the possible consequences, and what would you do?
- LO 5 9-71 *Ethical issues* During data collection for the transition from an old management accounting system to a new activity-based cost management system, you see a manager’s reported time allotments. You know that the data supplied by the manager are completely false. You confront the manager, and she states that she is worried that if she reports how she actually spends her time, her job will be altered, and it will also be found out that she is really not performing very well. She implores you not to tell anyone because she has needed to take time off to care for her chronically ill parents and needs the pay to help cover her parents’ medical expenses. What actions should you take? Explain.
- LO 5 9-72 *Ethical issues* You are a management accountant working in the controller’s office. Rick Koch, a very powerful executive, approaches you in the parking lot and asks you to do him a favor. The favor involves falsifying some of his division’s records on the main computer. The executive states that if you do not do as he asks, he will have you fired. What do you do? Explain.
- LO 6, 7 9-73 *Approaches to control* Cite two settings or jobs where each of the following approaches to control would be appropriately applied. Identify what you feel

is the definitive characteristic of the setting that indicates the appropriateness of the approach to control that you have identified:

- a. Preventive control
- b. Monitoring
- c. Results control

- LO 2, 3, 6, 8** 9-74 *Characteristics of MACS: types of information* Under what circumstances should both quantitative and qualitative performance measures be used to evaluate employee, work group, and divisional performance? Provide examples to support your answer.
- LO 3, 6** 9-75 *Evaluating system performance* Suppose that you are the manager of a production facility in a business that makes plastic items that organizations use for advertising. The customer chooses the color and quantity of the item and specifies what is to be imprinted on the item. Your job is to ensure that the job is completed according to the customer's specifications. This is a cutthroat business that competes on the basis of low price, high quality, and good service to the customer. Recently you installed a just-in-time manufacturing system. How would you evaluate the performance of this system given the characteristics of your organization?
- LO 9** 9-76 *Characteristics of MACS design: participation and education* Explain how participating in decision making and being educated to understand information received in an organization contribute toward employee empowerment in MACS design.
- LO 10** 9-77 *Methods of setting budgets* Megan Espanoza, manager of the Wells Division of Mars, Inc., a large credit card company, recently received a memorandum describing the company's new budgeting process for the coming year. The new process requires Megan and the other division managers to submit a budget proposal outlining their operating plans and financial requirements. Management would then study the proposals and determine the budget for each division.

Required

- (a) What is this form of budgeting called?
- (b) What are the pros and cons of this approach? Explain.

- LO 9** 9-78 *Methods of designing budgets* Budgets are usually set through one of three methods: participation, authority, or consultation.

Required

Write an essay stating the circumstances under which each method is most appropriate. If you disagree with a particular method, justify your answer.

- LO 9** 9-79 *Budgeting: motivational issues* Manoil Electronics manufactures and sells electronic components to electronics stores. The controller is preparing her annual budget and has asked the sales group to prepare sales estimates. All members of the sales force have been asked to estimate sales in their territory for each of the organization's 10 major products.

The marketing group is paid a salary and a commission based on sales in excess of some target level. You have discovered that the sales manager uses the sales estimates to develop the target levels at which commissions begin. Specifically, the sales manager takes the sales estimate, adds 10%, and the result becomes the sales hurdle level. If sales are less than the hurdle level, no commissions are paid. If sales are above the hurdle level, commissions are paid at varying rates.

Required

- (a) What is the motivation of the sales force if they know the relationship between their estimate and the target level of sales?
- (b) What is the likely consequence of basing the organization's budgets on these estimates?
- (c) If you were the controller in this situation and were responsible for both the reward system and the budgeting system, what would you do?

LO 10 9-80 *Budget slack* Mike Shields was having dinner with one of his friends at a restaurant in Memphis. His friend, Woody Brooks, a local manager of an express mail service, told Mike that he consistently overstated the amount of resources needed in his budget requests for his division. He also told Mike that year after year he was able to obtain the budget requested. When Mike asked him why he did this, Woody replied, "It's a dog-eat-dog world out there. If I'm going to succeed and move up the ladder, I've got to perform well. Having those extra resources really helps!"

Required

Write an essay discussing Woody's point of view related to budgeting. Is he justified in his approach? Explain.

LO 11 9-81 *Characteristics of MACS design: rewards* What are some pros and cons of tying an individual's pay to performance?

LO 11 9-82 *Designing reward structures* Answer the following two questions about the organization units listed below:

- What behavior should be rewarded?
- What is an appropriate incentive compensation system?
 - a. A symphony orchestra
 - b. A government welfare office
 - c. An airline complaint desk
 - d. A control room in a nuclear power-generating facility
 - e. A basketball team

LO 6, 11 9-83 *Designing a compensation plan* Suppose that you are the owner/manager of a house-cleaning business. You have 30 employees who work in teams of three. Teams are dispatched to the homes of customers where they are directed by the customer to undertake specific cleaning tasks that vary widely from customer to customer.

Your employees are unskilled workers who are paid an hourly wage of \$9. This wage is typical for unskilled work. Turnover in your organization is quite high. Generally, your best employees leave as soon as they find better jobs. The employees that stay are usually ones who cannot find work elsewhere and have a poor attitude.

The hourly rate charged customers per team hour is \$40. That is, if a team spends 1.5 hours in a customer's home, the charge is \$60.

You want to develop an incentive system to use in your organization. You would like to use this incentive system to motivate good employees to stay and motivate poor workers either to improve or to leave. What type of system would you develop? If the system relies on any measurements, indicate how you would obtain these measurements.

LO 6, 11 9-84 *Motivating desired performance* DMT Biotech is a biotechnology research and development company that designs products for the needs of life science researchers. The company consists of an administrative unit, a research

laboratory, and a facility used to develop prototypes of and produce new products. The major costs in this company are the salaries of the research staff, which are substantial.

In the past, the research scientists working at DMT Biotech have been rewarded on the basis of their proven scientific expertise. Salaries of these research scientists are based on the level of education achieved and the number of research papers published in scientific journals. At a recent board of directors meeting, an outside director criticized the research and development activities with the following comments:

There is no question that we have the most highly trained scientists in our industry. Evidence of their training and creativity is provided by the number of research publications they generate. However, the knowledge and creativity are not translating into patentable inventions and increased sales for this company. Our organization has the lowest rate of new product introduction in our industry, and we have one of the largest research and development teams. These people are too far into basic research, where the rewards lie in getting articles published. We need these people to have more interest in generating ideas that have commercial potential. This is a profit-seeking organization, not a university research laboratory.

Required

- Assuming that the director's facts are correct, do you agree that this is a problem?
- The board of directors has ordered the president of DMT Biotech to increase the rate of new product introduction and the time devoted to new product development. How should the president go about this task?

LO 11 9-85 *Profit-sharing plan at Hoechst Celanese* Hoechst Celanese, a pharmaceutical manufacturer, has used a profit-sharing plan, the Hoechst Celanese Performance Sharing Plan, to motivate employees. To operationalize the plan, the Hoechst Celanese executive committee set a target earnings from operations (EFO). This target was based on the company's business plans and the economy's expected performance. The performance sharing plan also used two other critical values: the earnings from operations threshold amount and the earnings from operations stretch target. The targets for 1994 are shown here:



The plan operates as follows. If earnings from operations fall below the threshold value, there is no profit sharing. If earnings from operations lie between the threshold amount and the target, the profit-sharing percentage is prorated between the threshold award of 1% and the target payment of 4%. For example, if earnings from operations were \$285 million, the profit-sharing percentage would be 2.5%:

$$\begin{aligned} \text{Profit-sharing percentage} &= 1\% + \{3\% \times [(285 - 250)/(320 - 250)]\} = 2.5\% \\ \text{Profit-sharing pool} &= 2.5\% \times \$285,000,000 = \$7,125,000 \end{aligned}$$

If earnings from operations are between the target and the stretch target, the profit-sharing percentage is prorated between the target payment of 4% and the stretch-sharing payment of 7%. For example, if earnings from operations were \$350 million, the profit-sharing percentage would be 5.29%, and the profit-sharing pool would be \$18.5 million:

$$\begin{aligned}\text{Profit-sharing percentage} &= 4\% + \{3\% \times [(350 - 320)/(390 - 320)]\} \\ &= 5.28571\%\end{aligned}$$

$$\text{Profit-sharing pool} = 5.28571\% \times \$350,000,000 = \$18,500,000$$

If earnings from operations equal or exceed the stretch target level, the profit-sharing pool would be \$27.3 million:

$$\text{Profit-sharing pool} = 7\% \times \$390,000,000 = \$27,300,000$$

Required

- List, with explanations, what you think are desirable features of the Hoechst Celanese performance sharing plan.
- List, with explanations, what you think are the undesirable features of the Hoechst Celanese performance sharing plan.
- The EFO for 1994 was \$332 million. Compute the size of the profit-sharing pool.
- In 1995, the performance sharing plan parameters were threshold EFO—\$420 million; target EFO—\$490 million; and stretch EFO—\$560 million. What do you think of the practice of raising the parameters from one year to the next?

LO 11 9-86 *Profit sharing* Peterborough Medical Devices makes devices and equipment that it sells to hospitals. The organization has a profit-sharing plan that is worded as follows:

The company will make available a profit-sharing pool that will be the lower of the following two items:

- 40% of income before taxes in excess of the target profit level, which is 18% of net assets, or
- \$7 million.

The individual employee is paid a share of the profit-sharing pool equal to the ratio of that employee's salary to the total salary paid to all employees.

Required

- If the company earned \$45 million of earnings before taxes and had net assets of \$100 million, what would be the amount available for distribution from the profit-sharing pool?
- Suppose that Marg Watson's salary was \$68,000 and that total salaries paid in the company were \$25 million. What would Marg's profit share be?
- What do you like about this profit-sharing plan?
- What do you dislike about this profit-sharing plan?

LO 11 9-87 *Gain sharing* Sakura Snack Company manufactures a line of snack foods, such as cheese crackers, granola bars, and cookies. The production workers are part of a gain-sharing program that works as follows: A target level of labor costs is set that is based on the achieved level of production. If the actual level of labor costs is less than the target level of labor costs, the difference is added to a cumulative pool that is carried from year to year. If the actual level of labor costs exceeds the target level, the amount of the excess is deducted from the cumulative pool.

If the balance of the pool is positive at the end of any year, the employees receive half the balance of the pool as part of a gain-sharing plan, and the balance of the pool is reset to zero. If the balance of the pool is negative at the end of any year, the employees receive nothing, and the negative balance is carried to the following year.

In any year when the target level of costs exceeds the actual level of costs, the target level for the following year is based on the actual level of cost performance in the previous year.

Required

- (a) Suppose that the target level of performance is set using the following labor use standards: (1) 0.20 labor hour per case of snack food A, (2) 0.15 labor hour per case of snack food B, (3) 0.25 labor hour per case of snack food C, and (4) 0.10 labor hour per case of snack food D. During the last year, production levels of snacks A, B, C, and D were 200,000 cases, 220,000 cases, 130,000 cases, and 240,000 cases, respectively. The company used 110,000 labor hours during the year, and the average cost of labor was \$16 per hour. What is the amount available for distribution to employees under this gain-sharing program, assuming no prior balance in the pool?
- (b) What do you like about this program?
- (c) What do you dislike about it?

LO 11 9-88 Scanlon plan Knox Company manufactures consumer products such as cleansers, air fresheners, and detergents. During a recent quarter, the value of the products made was \$50 million, and the labor costs were \$3 million. The company has decided to use a Scanlon plan with this quarter being used to establish the base ratio for the plan.

The formula is to be applied quarterly with differences, positive or negative, added to the bonus pool. Differences are calculated as the difference between the base ratio and the actual ratio for each quarter. The pool is to be distributed on a 35%/65% basis between the employees and the company at the end of the fourth quarter.

The following production and cost levels were recorded during the first year of the plan's operation:

QUARTER	PRODUCTION VALUE	PAYROLL COSTS
1	\$45,000,000	\$2,475,000
2	60,000,000	3,480,000
3	55,000,000	3,575,000
4	48,000,000	2,832,000

Required

- (a) How much would be distributed to the employees at the end of the year?
- (b) What assumptions does the Scanlon plan make about the behavior of payroll costs?
- (c) What formula should be used to determine each employee's share?
- (d) Management proposes to adjust the base ratio using the lowest ratio experienced in any year. Do you think this is a good idea?

LO 11 9-89 Choosing what to reward During the late 1970s, Harley-Davidson, the motorcycle manufacturer, was losing money and was very close to bankruptcy. Management believed that one of the problems was low productivity and, as a result, asked middle managers to speed up production. The employees who made the motorcycles were told that the priority was to get the motorcycles made and shipped on schedule, which was usually very tight. Middle managers were judged by their ability to meet shipment schedules.

Required

- (a) What is the rationale that would lead to a desire to speed production in the face of increasing costs and declining productivity?
- (b) What type of behavior do you think this performance measurement system would create in the sense of the priorities that middle management would establish for the production process?
- (c) What type of problems would this performance measurement system create?
- (d) How, if at all, would you modify this system?

LO 11 9-90 *Characteristics of MACS design: participation versus imposition* Denver Jack's is a large toy manufacturer. The company has 100 highly trained and skilled employees who are involved with six major product lines, including the production of toy soldiers, dolls, and so on. Each product line is manufactured in a different city and state. Denver Jack has decided to make all of the production decisions for the toy lines himself, including which products to eliminate. The managers of each toy line believe he is making a mistake.

Required

What are the pros and cons of Denver Jack's approach?

LO 11 9-91 *Evaluating a compensation plan* Beau Monde, Inc., a manufacturer and distributor of health and beauty products, made the following disclosure about its compensation program:

Our compensation philosophy is based on two simple principles: (1) We pay for performance and (2) management cannot benefit unless our shareholders benefit first.

Executive compensation at Beau Monde consists of three elements: base salary, bonus, and stock awards. Frankly, we see base salaries and the underlying value of restricted stock as what you have to pay to get people in the door—fixed costs, if you will. Incentives, in the form of annual cash bonuses and gains tied to increases in the price of our stock, are the performance drivers of our pay equation—the variable costs.

The first element is base salary. Our philosophy is to peg salary levels at median competitive levels. In other words, we pay salaries that are sufficient to attract and retain the level of talent we require.

The second element of our executive compensation is our bonus plan. This plan is based on management by objectives. Each year, the compensation committee approves objectives and performance measures for the corporation, our divisions, and our key individual managers. At year end, bonuses are paid on the basis of measurable performance against these objectives.

The third element of our executive compensation program is stock incentives, namely, restricted stock and stock options.

Our restricted stock program is very straightforward. Stock option grants are made each year at market value. Our options vest over time periods of two to six years to encourage long-term equity holding by management.

In 1998, we instituted an innovative stock incentive plan called the Stock Option Exchange Program. Under this program, management can purchase stock options by exchanging other forms of compensation, such as the annual bonus or restricted stock, for the options. The price

charged for the options is determined by an independent investment banker using pricing mechanics.

Our compensation committee is made up entirely of independent outside directors. We have no interlocking directorates, in which I serve on the compensation committee of one of my director's companies and he or she serves on mine. The compensation committee uses outside advisers chosen independently to ensure that recommendations are fair to all shareholders.

Required

Evaluate this incentive compensation plan.

- LO 11** 9-92 *The mix of salary and commission* Belleville Fashions sells high-quality women's, men's, and children's clothing. The store employs a sales staff of 11 full-time employees and 12 part-time employees. Until recently, all sales staff were paid a flat salary and participated in a profit-sharing plan that provided benefits equal to about 5% of wages. Recently, the manager and owner of Belleville Fashions announced that in the future all compensation would be commission based. The initial commission rate was set equal to the rate that would have caused the actual wage bill based on the old system to be equal to what the wage bill would have been under the commission system. Profit sharing was discontinued.

Required

- What do you think of this change?
- Describe some of the reactions that the owner might hear from the sales staff when announcing this change.
- Do you think that the method of determining the commission rate was appropriate?
- Describe what you think will happen under the new system.

- LO 11** 9-93 *Salary and job responsibilities* Marie Johnston, the manager of a government unemployment insurance office, is paid a salary that reflects the number of people she supervises and the number of hours that her subordinates work.

Required

- What do you think of this compensation scheme? What incentives does this compensation scheme provide to Marie?
- What would you recommend as an appropriate performance measurement and reward system?

- LO 11** 9-94 *Distributing a bonus pool* Four broad approaches to distributing the proceeds of a bonus pool in a profit-sharing plan are listed here:

- Each person's share is based on salary.
- Each person receives an equal share.
- Each person's share is based on position in the organization (larger payments to people at higher levels).
- Each person's share is based on individual performance relative to some target.

Required

- Give two reasons to support each alternative.
- Give two reasons to oppose each alternative.
- Pick the alternative that you think is best and support your choice with an argument of no more than 100 words.

Cases

LO 3, 6 9-95 *Characteristics of MACS design: types of information* Chow Company is an insurance company in Hong Kong. Chow hires 55 people to process insurance claims. The volume of claims is extremely high, and all claims examiners are kept extremely busy. The number of claims in which errors are made runs about 10%. If a claim has an error, it must be corrected by the claims examiners. After looking at the data, Judy Choy, senior manager of the division, was not satisfied with the volume of claims processed. She instructed Anne Wu, the manager, to motivate the claims examiners to work faster. Judy believes that the claims examiners are working as fast as they possibly can. She is also concerned that, by working faster, the examiners will make more errors.

Required

- (a) How should Anne Wu handle this situation?
- (b) On what performance measures is the organization relying?
- (c) What performance measures should the organization use?

LO 5 9-96 *Ethical control frameworks* In December 2002, *Time* magazine named Cynthia Cooper, Coleen Rowley, and Sherron Watkins as its Persons of the Year. Cynthia Cooper was vice president of internal audit for WorldCom and informed the firm's audit committee that the firm had improperly treated billions of dollars as capital expenditures rather than properly treating them as period expenses. Coleen Rowley was an FBI attorney who wrote a 13-page memo describing deficiencies in the FBI. Sherron Watkins was vice president at Enron and informed chairman Kenneth Lay of her serious concerns about Enron's financial reporting. Select one of the two accounting-related situations (WorldCom or Enron) to answer the following questions on the basis of the *Time* magazine Person of the Year articles or other articles.

Required

- (a) How did Cooper and Watkins become aware of financial reporting problems within their companies?
- (b) Which of the nine alternatives listed on page 348 (or other variation) did Cooper or Watkins take? How did the public become aware of their concerns?
- (c) What pressures did Cooper or Watkins face to suspend their ethical judgments or drop their concerns? Who would have benefited if Cooper or Watkins had dropped their concerns?
- (d) What information is reported in the article about WorldCom's or Enron's code of ethics, communication of the code, and system of reporting violations of the code?
- (e) What role did personal norms play in Cooper's and Watkins's decisions to report the problems they had discovered?
- (f) What consequences did Cooper and Watkins face for reporting the problems?
- (g) If you had been in Watkins's or Cooper's place, what would you have done?

LO 8, 11 9-97 *Compensation tied to Balanced Scorecard, degree of difficulty of target achievement* Discuss Case 2-48.

LO 6, 8, 11 9-98 *Multiple performance measures to evaluate and reward performance; subjective evaluation*

*Citibank: Performance Evaluation*³

Frits Seegers, President of Citibank California, was meeting with his management team to review the performance evaluation and bonus decisions for the California branch managers. James

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McGaran's performance evaluation was next. Frits felt uneasy about this one. McGaran was manager of the most important branch in the Los Angeles area, and his financials were impressive. A year ago he would have received "above par" rating with full bonus. But last year, the California Division of Citibank had introduced a new performance scorecard to highlight the importance of a diverse set of measures in achieving the strategic goals of the division. Among the new measures introduced was a customer satisfaction indicator. Unfortunately, James McGaran had scored "below par" on customer satisfaction.

Frits looked at Lisa Johnson, the area manager supervising James McGaran. Frits had read Lisa's comments (Exhibit 9-2). The comments were very positive, but Lisa had not wanted to give a final recommendation until she had discussed it with Frits. She knew that James' case would be watched closely by many managers within the division.

The Financial District Branch

James McGaran was manager of the most important of the 31 branches in the Los Angeles area. Located in Los Angeles's financial district, James's branch had a staff of 15 people, revenues of \$6 million, and \$4.3 million in profit margin. The customer base was very diverse. Individual customers ranged from people who worked in the financial district with sophisticated retail banking needs to less informed individuals banking for convenience. Business customers were sophisticated buyers who demanded high service quality and knowledgeable employees who could satisfy their financial needs. "Mom and pop" businesses, the dominant segment in other regions, were also present but to a much lesser extent. Competition was intense. Two competitors—Bank of America and Wells Fargo—had offices less than a block away from James's branch.

James joined Citibank in 1985 as assistant branch manager. He had worked in the banking industry since 1977. Within a year, in 1986, he was promoted to manager of a small branch. He progressed quickly through the ranks until 1992 when he was given the responsibility of managing the Financial District office. His performance in this office had exceeded expectations every single year. He had delivered impressive financial results for four years in a row. In 1996, when the division expanded its performance indicators to include non-financial measures, it became apparent that his branch's customer satisfaction ratings did not follow the same pattern as its financial performance.

James reported to Lisa Johnson, Los Angeles area manager. Lisa was a long time employee of Citibank. She joined the company in 1978 in Chicago and moved to California in early 1988. Her area was the biggest in the division and included two regions that had previously been managed separately. Lisa was a hands-on manager who spent a lot of time in the branches supporting the managers and becoming familiar with the events in each branch.

New Performance Scorecard

Citibank was a niche player in the California market. It had eighty branches compared with four hundred offices of its biggest competitor. Citibank's strategy in California was to build a profitable franchise by providing relationship banking combined with a high level of service to its customers. Service was delivered face to face (in the branch) or remotely, depending on the wishes of the customers. Customers' service expectations rose in line with their net worth, as did their profitability for the bank. These customers demanded high levels of service with careful personal attention and a broad selection of financial products. Citibank provided a broad array of services including a dense network of ATM machines, 24 hour banking, and home banking.

Financial measures had dominated Citibank's performance evaluation in the past. But top managers in the division felt that these measures were poor vehicles to communicate the high service strategy of the bank. Frits Seegers wanted people in the division to have a broader view of the business and focus their attention on those dimensions that were critical to the long term success of the franchise.

To reflect the importance of non-financial measures as leading indicators of strategy implementation, the California Division developed a Performance Scorecard. It complemented existing

Exhibit 9-2

James McGaran's Year-End Performance for 1996

			Below Par	Par	Above Par	YEAR-END PERFORMANCE ASSESSMENT
FINANCIAL	Total	Above plan	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	James had an exceptional year. The branch grew \$56 million or 39% in footings, ranking #1 in the marketplace. Contribution margin was \$4.3 million for the year, ranking the branch #1 in the marketplace. Expenses were \$88.5 thousand better than plan for the year. Contribution margin improved by 48% from 4Q95 to 4Q96.
	Revenue	\$ 6 million				
	Expense	\$1.7 million				
	Margin	\$4.3 million				
STRATEGY IMPLEMENTATION			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	The branch enjoyed strong growth in business, professional, and retail. Citigold began to pick up in the third and fourth quarter. The branch's new household acquisition of 21% was impressive. Annualized attrition was 12% in 1996. James grew balances in all business segments: retail balances improved \$2.4 million, Citigold increased \$18 million, and business and professional increased \$34.8 million.
CUSTOMER SATISFACTION			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Full-year service scores showed mixed results, 66 1Q, 63 2Q, 54 3Q, 72 4Q. James identified areas of opportunity and put corrective measures in place that allowed him to improve service scores substantially by year-end.
CONTROL	Operating losses	\$81,960	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	The branch received two "5" audit ratings in 1996. James is a very conscientious manager and works closely with his SCM to ensure operational compliance all times. Due to the sheer volume of transactions, the branch sustained substantial operating and fraud losses, over \$137 thousand full-year. Some of these losses were from prior years, others were beyond branch control. Still, there is room for improvement in this area.
	Fraud losses	\$55,920				
PEOPLE	Performance Management		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	James is an excellent people manager. His Viewpoint results were amongst the best in the Area. He is a team-builder in his branch and motivates his people to go above and beyond. James had minimal turnover in 1996. James is one of the most consistent managers in the Area. His daily meetings are well-planned and productive. He instills focus and discipline in his branch. James is viewed as a team-player in the Area. He is quick to volunteer to help his peers or participate on special projects. James has been working on his MBA and has nearly completed the comprehensive Credit training program.
	Teamwork					
	Training / Development					
	Employee Satisfaction					
STANDARDS	Leadership		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	James has very high standards for himself and those in his employ. He is well respected for his strong leadership skills. He showed sincere concern for his customer service scores and did whatever was necessary to improve customer satisfaction. James and his team are very involved in the local community. James has taken an active role in developing a business network within the community. He also served as a board member on the American Heart Walk campaign. James's people are also involved in various community groups.
	Business Ethics / Integrity					
	Customer Interaction / Focus					
	Community Involvement					
	Contribution to Overall Business					
OVERALL EVALUATION			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	This has been an exceptional year for James. From a financial perspective, his branch was rated #1 in the marketplace. His willingness and ability to look outside the box to close a deal are admired and respected. He has done an excellent job refining his management style, becoming one of the most effective leaders and coaches in the marketplace. James is dedicated to the success of the business, as evidenced by his willingness to work weekends, holidays, and during his vacation to ensure customer satisfaction, operational control, and financial growth. James is an outstanding manager. Congratulations on a job well done!!
Signed by Area Manager: _____			Approved by Regional President: _____			

financial measures with new measures reflecting important competitive dimensions in the bank's strategy. The initial version was pre-tested in 1995 and, starting in the first quarter of 1996, Performance Scorecard goals and performance data became a central management tool to implement strategy and evaluate performance.

The Performance Scorecard was built around six different types of measures: financial, strategy implementation, customer satisfaction, control, people, and standards (see Exhibits 9-3 to 9-6).

Financial measures were obtained from the regular accounting system and focused primarily on total revenue and profit margin against targets.

Strategy implementation measures tracked revenue for different types of target customer segments relevant to the strategy of the branch. James's Performance Scorecard focused primarily on revenues from retail customers—households, businesses, and professionals.

Customer satisfaction was measured through telephone interviews with approximately twenty-five branch customers who had visited the branch during the past month. Customer satisfaction scores were derived from questions that focused on branch service as well as other Citibank services like 24 hours phone banking and ATM services. An independent research firm was responsible for administering the survey under the guidance of the division's Relationship Satisfaction department. Given the current strategy of the bank, which focused on customer service as a key differentiator, Frits Seegers considered the customer satisfaction measure as critical to the long term success of his division. He saw it as a leading indicator of future financial performance. If customer satisfaction deteriorated, it was only a matter of time before it showed in the financials.

Control measures reported the evaluation by internal auditors on the branch's internal control processes. Branches had to score at least par (defined as 4 on a scale of 1 to 5) to be eligible for any bonus. If the rating was below 4, the branch's business was considered at risk and did not meet the minimum requirements for effective control.

People and Standards were non-quantifiable ratings determined subjectively by the branch manager's boss. The "people" measure focused on the proactive efforts of the manager to develop and communicate with subordinates, to encourage area training programs, and to be a role model to more junior people. Standards included an assessment of a manager's involvement in community groups, trade associations, and business ethics.

Each component of the Scorecard was scored independently into one of three rating categories: "below par," "par," or "above par." For those measures that could be measured quantitatively—financial, strategy implementation, customer satisfaction, and control—pre-defined performance thresholds determined where performance fell in this three-level scale. However, ratings related to people and standards lacked an appropriate objective indicator: in these cases performance was determined subjectively by the branch manager's superior.

In addition, the manager's boss gave a global rating for each of the six components of the Scorecard and an overall rating for the branch manager.

Performance and Incentives

The performance planning process started in October with a negotiation process between Frits Seegers and his area managers. At the end of this initial stage, Performance Scorecard targets for the upcoming year were established for the division and for each area. These targets were cascaded down the organization. Area managers negotiated with branch managers to determine their financial targets and strategy implementation goals for the year. At the end of this process, the targets for branch managers were added up to ensure that they equaled or exceeded the area's targets.

Customer satisfaction and control goals were common to all branches in the division. For customer satisfaction, the 1996 goal was to achieve a rating of at least 80.

Financial, strategy implementation, customer satisfaction, and control targets formed the quantitative basis for *ex post* performance evaluation. Each quarter, area managers received branch information with the actual numbers for each of these measures and a comparison with the quar-

Exhibit 9-3

James McGaran's Performance Scorecard for the First Quarter of 1996

	Below			Above			1996 RESULTS				1996 GOALS			
	Par	Par	Par	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter			
FINANCIAL	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
Revenue	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	1,250,094				1,134,276	1,206,442	1,325,692	1,416,242			
Expense	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	421,430				403,586	417,972	414,900	414,900			
Margin	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	828,664				730,690	788,470	910,792	1,001,342			
STRATEGY IMPLEMENTATION	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>											
Total Households	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	3,228										
New to bank households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	257										
Lost to bank households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	(93)										
Cross-sell, splits, mergers households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	4										
Retail asset balances	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	\$ 5,578										
Market share	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	1.8%										
CUSTOMER SATISFACTION	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Score 66	Goal 80	The branch has shown significant and sustained improvement in customer satisfaction.								
CONTROL	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
Audit	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Score 4	Goal 4	The branch demonstrates strong operational control.								
Legal / Regulatory	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
PEOPLE	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James is a strong manager. He has inculcated a disciplined sales process and reinforces it with a daily focus on how the business, branch, and individuals are doing vs. goal.										
Performance Management	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
Teamwork	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James is currently working on his MBA degree.										
Training / Development	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
Self	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James works closely with his staff, coordinating the necessary training programs either in branch or in the classroom. His daily meeting and coaching sessions have allowed him to increase the knowledge and professionalism of his people.										
Other	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
Employee Satisfaction	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
STANDARDS	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James provides clear and concise direction in his branch. He acts professionally, earning the respect of his staff, colleagues, and customers. James has built a cohesive team and leads by example.										
Leadership	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James consistently upholds all bank standards and ensures appropriateness of action for himself and his staff.										
Business Ethics / Integrity	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Excellent progress in customer interaction.										
Customer Interaction / Focus	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James proactively develops and implements effective programs to enhance Citibank's image as socially responsible. He and his staff are involved in a number of community groups in Los Angeles.										
Community Involvement	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James makes significant contribution to the business. The branch is currently the highest revenue and margin producer in the market place. James and his team grew revenue by \$142.2 million or 16%.										
Contribution to Overall Business	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>											
OVERALL EVALUATION	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James takes complete ownership of his branch and leverages internal and external relationships to grow the business and solve problems. He has demonstrated his ability to consistently outperform the branch's aggressive financial goals.										

Signed by Area Manager: 

Exhibit 9-4

James McGaran's Performance Scorecard for the Second Quarter of 1996

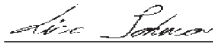
	Below			Above			1996 RESULTS				1996 GOALS			
	Par	Par	Par	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter			
FINANCIAL	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Revenue	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	1,254,876	1,486,172			1,141,612	1,213,744	1,332,865	1,423,454			
Expense	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	421,430	378,959			403,586	436,276	436,806	437,282			
Margin	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	833,446	1,107,213			738,026	777,468	896,059	986,172			
STRATEGY IMPLEMENTATION	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Total Households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	3,403	3,438									
New to bank households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	257	162									
Lost to bank households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	(93)	(119)									
Cross-sell, splits, mergers households	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	4	(7)									
Retail asset balances	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	\$ 5,578	\$ 5,402									
Market share	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	1.8%	1.8%									
CUSTOMER SATISFACTION	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Score 63	Goal 80	The score is down 3 points. James and his team need to work on customer satisfaction.								
CONTROL	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Score 5	Goal 5	An exceptional score given the size and complexity of the branch.								
Audit	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Legal / Regulatory	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
PEOPLE	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James fosters a strong sense of teamwork, as evidenced by his Viewpoint results and employee satisfaction scores. James maintains very high development standards for himself and his staff.										
Performance Management	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Teamwork	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Training / Development	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	He is currently working on his MBA degree and should graduate in 1997. James also actively promotes cross-training and self-development.										
Self	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Other	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Employee Satisfaction	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
STANDARDS	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James is recognized throughout the business as one of California's finest managers. He has demonstrated strong leadership skills and a keen understanding of the business.										
Leadership	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Business Ethics / Integrity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Customer Interaction / Focus	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	The branch, under James's leadership, has made a major contribution to the marketplace. The branch's margin contribution of \$1,108M, exceeds the next closest branch by 53%.										
Community Involvement	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
Contribution to Overall Business	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>											
OVERALL EVALUATION	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	James had another exceptional quarter. The branch exceeded its margin goal by 22%. Total margin contribution improved 33%, total footings increased by 9.4%, and revenue increased 18.4%. Congratulations on another outstanding quarter.										
Signed by Area Manager:														

Exhibit 9-5
James McGaran's Performance Scorecard for the Third Quarter of 1996

	Below			1996 RESULTS				1996 GOALS			
	Par	Par	Par	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter
FINANCIAL	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Revenue	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	1,254,876	1,486,172	1,593,690		1,141,612	1,213,744	1,429,974	1,423,454
Expense	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	421,430	395,216	378,458		403,586	436,276	445,688	437,282
Margin	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	833,446	1,090,956	1,215,232		738,026	777,468	984,286	986,172
STRATEGY IMPLEMENTATION	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Total Households	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	3,409	3,445	3,511					
New to bank households	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	257	162	152					
Lost to bank households	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	(93)	(119)	(100)					
Cross-sell, splits, mergers households	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	4	(7)	13					
Retail asset balances	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	\$ 5,578	\$ 5,402	\$ 5,437					
Market share	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	1.8%	1.8%	1.8%					
CUSTOMER SATISFACTION	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Score 54 Goal 80	Service scores continued to deteriorate in the 3rd. quarter. The branch ran short of one teller and desperately needs another two CBCs to offload the day time traffic in the branch.						
CONTROL	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Not reviewed this quarter.							
Audit	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>								
Legal / Regulatory	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>								
PEOPLE	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James has a very focused and disciplined sales process in his branch. His daily sales meetings have become the "model" for the Area.							
Performance Management	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Teamwork	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Training / Development	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Self	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James is currently working on his MBA degree and participating in the Commercial program.							
Other	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Employee Satisfaction	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Employee satisfaction is high in the branch, as evidenced by James's positive Viewpoint results.							
STANDARDS	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	James is highly respected in the Area as a seasoned manager and leader.							
Leadership	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Business Ethics / Integrity	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
Customer Interaction / Focus	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	James and his team are very involved in the local community.							
Community Involvement	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	James makes a tremendous contribution to the Area and the business. He has a "can do" attitude and often finds ways to make deals happen despite systems and back-office constraints.							
Contribution to Overall Business	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>								
OVERALL EVALUATION	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	James had another exceptional quarter. Financials improved in all aspects. Expenses were below plan and his contribution margin is the highest in the marketplace.							
Signed by Area Manager: <i>Alice Johnson</i>											

Exhibit 9-6
James McGaran's Performance Scorecard for the Fourth Quarter of 1996

	Below			Above			1996 RESULTS				1996 GOALS			
	Par	Par	Par	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter			
FINANCIAL	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Revenue	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	1,254,876	1,486,172	1,593,690	1,636,056	1,141,612	1,213,744	1,429,974	1,580,534			
Expense	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	421,430	395,216	378,458	456,061	403,586	436,276	445,688	454,076			
Margin	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	833,446	1,090,956	1,215,232	1,179,995	738,026	777,468	984,286	1,126,458			
STRATEGY IMPLEMENTATION	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Total Households	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	3,409	3,445	3,511	3,503							
New to bank households	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	257	162	152	102							
Lost to bank households	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	(93)	(119)	(107)	(128)							
Cross-sell, splits, mergers households	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	4	(7)	20	18							
Retail asset balances	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	\$ 5,578	\$ 5,402	\$ 5,437	\$ 5,510							
Market share	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	1.8%	1.8%	1.8%	1.8%							
CUSTOMER SATISFACTION	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	Score 72	Goal 80	Congratulations to James and his team for their improvement in service results.								
CONTROL	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Audit	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	Score 5	Goal 5	James maintains strong operational control in his branch.								
Legal / Regulatory	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
PEOPLE	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James is an exceptional performance manager. He communicates clear and concise expectations and manages his people to their best potential.										
Performance Management	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James is a consummate team player and fosters the same behavior in his branch.										
Teamwork	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	Self and employee development are a priority to James. He is currently working on his MBA degree and is attending comprehensive Credit training program.										
Training / Development	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James encourages his staff to develop themselves. He also looks for opportunities for them to attend Area or CitiSource training programs.										
Self	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James enjoys a high level of employee satisfaction, as evidenced by his Viewpoint results and low employee turnover.										
Other	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Employee Satisfaction	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
STANDARDS	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James is highly regarded as an effective leader and coach. His daily sales meetings have become the model for the other branches in the Area.										
Leadership	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	It's been a difficult year meeting customer expectations in the branch but James and his team have done an outstanding job managing the challenge.										
Business Ethics / Integrity	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James is very involved in the local community and proactively looks for opportunities for himself and his staff to create an awareness with local groups and establish Citibank as a model corporate citizen.										
Customer Interaction / Focus	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Community Involvement	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
Contribution to Overall Business	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>											
OVERALL EVALUATION	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	James has done an exceptional job. The branch was rated #1 in the marketplace. It generates the highest revenue and makes the greatest margin to the business. They have done all that while maintaining a 5 rated audits. Exceptional quarter and outstanding year!!										

Signed by Area Manager: *James McGaran*

terly objectives. This information, together with the subjective scores that the area manager gave for the People and Standards ratings, formed the basis for the quarterly and yearly evaluation of branch managers.

Year-end performance evaluation was determined jointly by a team led by Frits Seegers. The team comprised the area managers, including Lisa Johnson, and managers from human resources, quality, and finance. Frits believed that having a team jointly evaluate performance of every branch manager gave consistency to the process throughout the division. It was this team that was now meeting to decide James's performance evaluation for the year.

In addition to other motivational elements associated with the yearly evaluation, a branch manager's bonus was linked to his or her final Performance Scorecard rating. A "below par" rating did not carry any bonus. A "par" rating generated a bonus of up to 15% of the basic salary (for branch managers with a salary in the lower part of the salary bracket, the bonus could reach 20%). An "above par" rating could mean as much as 30% bonus.

Without "par" ratings in *all* the components of the Scorecard, a manager could not get an "above par" rating.

Performance of the Financial District Branch

Frits reviewed the 1996 performance evaluation forms for James McGaran. His financials were outstanding—20% above target. According to Lisa Johnson, James's branch "had generated the highest revenue and made the greatest margin contribution to the business of any branch in the system." His strategy implementation scores were in the "par" to "above par" range, although Lisa Johnson had given him an "above par" rating in three quarters. James had maintained an "above par" rating in the control scorecard and Lisa Johnson had rated him exceptionally where she had the discretion to do so.

However, customer satisfaction was "below par". A branch obtained a "par" rating if it scored 74 to 79. If customer satisfaction was above 80 or it had improved 6 points with no regression during 2 quarters and it was above the market average (77), then the branch got an "above par" rating.

Lisa and Frits were aware that a strict application of the new policies for performance evaluation meant that James could get at most a "par" evaluation for the year. But James's branch was the largest and toughest branch in the division. He had a demanding clientele and challenging competition. It was difficult to manage such a diverse set of indicators, and the customer satisfaction measure was sometimes hard to reconcile with demonstrated financial performance. James had discussed with Lisa his concerns regarding the adequacy of the survey. Customers rated not only their branch, but also other Citibank services such as ATM's that were out of the control of branch managers. Thus, it was possible that these centralized services were not providing adequate support to the sophisticated customers of James's branch.

Notwithstanding these concerns, James had worked hard to improve the customer satisfaction rating during the last quarter. He had made some changes in his staff to improve the score. One person in the branch was now dedicated to greeting the customer when arriving at the office and helping with any problems that may arise. He also held branch meetings and coached branch employees to focus their attention on improving customer satisfaction.

James gave a lot of importance to his ratings. It was a matter of pride to be "above par" and show that he was able to successfully run the hardest branch in the division. He had felt very disappointed when, in two quarters of the year, his rating had been only par. His branch was difficult and he was delivering the best financial performance in the division. He thought that his efforts deserved an above par rating, even if customer satisfaction was somewhat lagging.

Frits reviewed James's scorecards for each quarter of 1996 (Exhibits 9-3 to 9-6). His financials were exceptional, but only in the last quarter was he able to pull customer satisfaction to an acceptable level. If the performance evaluation team gave James an "above par" people could think that the division was not serious about its non-financial measures. James had been "below

par” in customer satisfaction for all quarters of 1996 and, if this measure was truly important, he should not get an “above par” rating. On the other hand, he deserved the above par given his excellent performance in other dimensions. James was a reference point for a lot of other branch managers.

Frits held the summary scorecard in his hand (Exhibit 9-2) and turned to Lisa Johnson:

“Lisa, I’ve read over your comments and reviewed James’s quarterly scorecards. All that now remains is ticking off the six boxes on this summary form and deciding on an overall performance rating for James . . . What do you recommend?”

Required

- (a) Why has Citibank introduced its Performance Scorecard? What benefits does Citibank expect the Performance Scorecard to provide?
- (b) What cause-and-effect linkages are implied in the Performance Scorecard?
- (c) What characteristics are desirable for measures used to evaluate and reward performance? Discuss the Performance Scorecard’s measures in relation to the characteristics you identified.
- (d) Assume that you are Lisa Johnson. Complete Exhibit 1 to evaluate James’s performance and explain your rationale for your rating on each of the six dimensions and the overall evaluation.