

Instructor's Manual

Management Control Systems

Performance Measurement, Evaluation, and Incentives

Fourth edition

Kenneth A. Merchant
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ISBN: 978-1-292-11056-1

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Second edition published 2007

Third edition published 2012

This edition published 2018

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ISBN 978-1-292-11056-1

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§ *New case* in this 4th edition of the text.

* *Updated case* from the 3rd edition of the text.

All other cases as in the 3rd edition.

Overview of changes in cases from the 3rd to the 4th edition:

Cases removed from 3e: 20

1. *Armco, Inc.: Midwestern Steel Division*
2. *Loctite Company De Mexico, S.A. de C. V.*
3. *Lincoln Electric Co.*
4. *AirTex Aviation*
5. *Toyota Motor Sales*
6. *Citibank Indonesia*
7. *HCC Industries*
8. *Patagonia, Inc.*
9. *Tsinghua Tongfang*
10. *First Commonwealth Financial Corporation*
11. *Southern California Edison*
12. *Formosa Plastics Group, Inc.*
13. *Financial Reporting Problems at Molex, Inc.*
14. *Landale PLC*
15. *ConAgra Grocery Products Company*
16. *Lincoln Electric: Venturing Abroad*
17. *TECO Electric & Machinery Co. Ltd.*
18. *City of Yorba Linda, California*
19. *Waikerie Co-Operative Producers Ltd.*
20. *Boston Lyric Opera*

Note: *These cases are still available for use. Please contact the authors and/or publisher for access to the case text and teaching notes.*

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1. *Office Solutions, Inc.*
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3. *EyeOn Pharmaceuticals, Inc.*
4. *Better Beauty, Inc.*
5. *Atlantis Chemical Industries*
6. *Wessanen NV*
7. *The Stimson Company*
8. *Multiple Versions of the Plan*
9. *Vitesse Semiconductor Corporation*
10. *Corbridge Industries, Inc.*
11. *King Engineering Group, Inc.*
12. *Dortmunder-Koppel GmbH*
13. *Johansen's: The New Scorecard System*
14. *Mainfreight*
15. *Howard Building Corporation, Inc.*
16. *Fine Harvest Restaurant Group (A) and (B)*
17. *Arrow Motorcar Corporation*
18. *Bio/Precise Medical Devices, Inc.*
19. *Andrew G. Scavell, Chief Risk Officer*
20. *Wired PLC*
21. *Mean Screens USA, Inc.*
22. *Ethics@Cisco*
23. *SCI Ontario: Achieving, Measuring, and Communicating Strategic Success*

Cases updated from 3e: 10 [indicated with * in the Table of Contents above]

1. *Axeon N.V.*
2. *Zumwald AG*
3. *Behavioral Implications of Airline Depreciation Accounting Policy Choices*
4. *Las Ferreterías de México, S.A. de C.V.*
5. *Industrial Electronics*
6. *Haengbok Bancorp*
7. *Olympic Car Wash*
8. *Hoffman Discount Drugs, Inc.*
9. *Desktop Solutions, Inc. (A) and (B)*
10. *Conservative Accounting in the General Products Division*

Introduction

One constant in the teaching of virtually all courses in management control systems (MCSs) is their heavy use of the case method of instruction. Even instructors who are most comfortable lecturing and/or who like to describe the management control issues through relatively formal (e.g., agency theory) models find it useful to use cases to illustrate the lecture points or the key parameters in the models. This textbook is set up to facilitate the teaching of MCS cases. In addition to the text material, the book includes 70 cases of great variety. Thus, it can be used in courses in which instructors use a case in virtually every class, or it can be used in courses in which only a few cases are used. The model syllabi in the following sections of this manual show this variation: there are syllabi for courses where there is a case in every session, and there are syllabi for courses that use a mixed approach where lectures (without cases) are followed by a session dedicated to the analysis of a case pertaining to the foregoing lecture.

Our own teaching style involves the use of many cases, with considerable student participation in the discussions. This type of course makes some students, particularly those who have not experienced a case course before, possibly uncomfortable, at least initially. We thus sometimes find it necessary to “sell” the advantages of the case method. To this end, instructors can use the note called “**The Case Method of Instruction: Suggestions for Students,**” which can be handed out either in or before the first day of class. This note is included in this manual for your consideration and possible use.

As for course organization, there is no single one-size-fits-all or “template” approach. Management control is a complex, multi-dimensional subject, and courses in MCSs can be organized in many ways. The outline of the textbook provides one way that we have found useful for organizing the materials. The model syllabi included in the following sections of this manual show some variation, which we have ourselves implemented and tweaked over the years depending on level, length, and purpose of the given course, among other considerations (e.g., whether or not there are visitors for some sessions or part of the course).

Even with the same outline, instructors can choose to use quite different sets of cases and different case orderings. This is because, unlike simple problems, most of the cases included in the book describe rich real-world examples, and real-world examples usually do not illustrate just one point.

Consider, for example, the Statoil case, which is included in Chapter 11 (Remedies to the Myopia Problem) because Statoil uses a key-performance-indicator (KPI) structure that is Balanced Scorecard-like to deal with some issues associated with more traditional approaches to performance measurement, as discussed in Chapter 10 (Financial Performance Measures and their Effects). But the case can also be used effectively with Chapter 8 (Planning and Budgeting) because Statoil separates the functions of target setting, forecasting and resource allocation using the principles of “Beyond Budgeting.” Statoil also relies quite substantially on subjective performance evaluations in determining incentives as discussed in Chapter 9 (Incentive Systems). Finally, students have to consider the industry characteristics, the organization structure, the characteristics of the personnel in key positions, and the company’s history (e.g., a recent merger), none of which are dealt with in any specific chapter but which are important to understand when evaluating the effectiveness of a MCS. All told, the case can be used to focus on any of these issues, but also as a powerful integrative case cutting across several topics related to the design and operation of a management control system. If the

instructor is looking to illustrate “Beyond Budgeting” in a more focused manner, then using the new Mainfreight case is probably a good choice. The Mainfreight case could have been slotted in Chapter 8 (Planning and Budgeting), but we slotted it in Chapter 11 (Remedies to the Myopia Problem) because the company is keen to try and mitigate the alleged dysfunctional consequences of presumably rigid and possibly myopic traditional budget and target setting processes.

To give another example, the Catalytic Solutions, Inc. case, which is included in Chapter 11 (Combinations of Measures and other Remedies to the Myopia Problem) to illustrate the use of nonfinancial performance measures, also can be effectively used with Chapter 2 (Results Controls), Chapter 6 (Designing and Evaluating MCSs), and Chapter 9 (Incentive Compensation Systems). It deals with designing and evaluating a new, first-time incentive system (Chapter 6) to motivate employees toward generating desired organizational outcomes (Chapter 2) that are primarily nonfinancial and long-term in nature (Chapter 11).

For a final example, consider the new case Andrew G. Scavell, Chief Risk Officer. We placed it in Chapter 14 because we also have the Don Russell, CFO case there. Both cases give students an insight into these important controller and risk management roles at the C-suite level. However, the Andrew Scavell case can also be taught pertinently with Chapter 13 focused on corporate governance and related board responsibilities and concerns, of which enterprise risk management (ERM) certainly is one. In Chapter 13, the Andrew Scavell case goes nicely together with the Entropic Communications, Inc. case. Indeed, instructors who wish to spend a bit more time on risk management could easily teach both the Entropic and Andrew Scavell cases, in this order in two consecutive sessions, (which would allow assigning Chapters 13 and 14, respectively, as the key reading for each of the consecutive sessions accordingly). The Andrew Scavell case also discusses the implementation process of the “new” ERM system, which dovetails with the coverage in Chapter 6—designing and evaluating MCSs. Finally, given the intricate connection of ERM in this case company with the planning and budgeting systems, the case also could be taught in connection with Chapter 8.

Because we can slot each case in only one chapter, and to help instructors with their case choice decisions, we included in this manual a so-called “**Case Matrix**” showing the multiple links between cases and chapters.

The following pages also show several course organizations we use in various teaching programs. The first syllabus (**Model Syllabus 1**) is for an undergraduate half-semester course taught in a two-classes-per-week format over 7 weeks. The second syllabus (**Model Syllabus 2**) shows the contents of a 5-week module focused on management control as part of a 4-module senior undergraduate management accounting course taught in a two-classes-per-week format (through a combination of weekly lectures and seminars). The third syllabus (**Model Syllabus 3**) is for a 15-week semester-long elective course in the MBA program, thus providing 30 sessions (2 class meetings per week) of materials in this topic area. The fourth syllabus (**Model Syllabus 4**) shows a 10-week term format to offer these materials to MSc students, again through two meetings per week. For this course, the first session of the week is usually lecture-like, whereas the second one is focused on a case analysis related to that week’s topic. The final syllabus (**Model Syllabus 5**) is essentially Model Syllabus 3 but offered as a single 3-hour class meeting per week. A format with one long class each week makes it difficult, but not impossible, to use two cases each week. Instead of using two cases, instructors may choose to use lectures, in-class exercises, video clips, etc., to break up the format.

You will also see that we used some cases “out of order,” that is, in conjunction with a chapter reading different from the chapter in which the case is included in the book. That is why

we emphasize that both the inclusion of the cases in the chapters and these guides are merely illustrative. We encourage instructors to adapt the materials to their own organization and teaching emphasis. In so doing, we hope that the alternatives illustrated in the case matrix will prove helpful.

Finally, some teaching materials have been made available electronically on the publisher's website (www.pearsoned.co.uk/merchant). These include, particularly, instructional PowerPoints for each chapter of the book developed by the second author of this book, as well as databases and Excel spreadsheets for the Vitesse Semiconductor Corporation case; the VisuSon, Inc. case; the Bank of the Desert (A) and (B) cases; and the Fine Harvest Restaurant Group (A) and (B) cases.

The Table of Contents also shows which cases have been removed from the prior edition, which ones are new to this edition, and which have been updated. Instructors wishing to continue to use some of the cases that we may have removed, please contact the authors and/or publisher for access to these cases and teaching notes. Please also contact us with any other suggestions or comments. We can be reached at:

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Model Syllabus 1

Accounting 476—Performance Measurement Issues

Leventhal School of Accounting, University of Southern California

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Class Hours	Tue/Thu 2:00–3:50 p.m.
Classroom	ACC 310
Office Hours	By appointment. Arrange by e-mail. I will do my best to accommodate your schedule.
Prerequisites	ACCT 372
Honor Code	The Leventhal School Student Honor Code took effect on September 1, 1993. All students are subject to the Code and are responsible for familiarizing themselves with it. If needed, copies may be obtained from the receptionist in ACC 101.
Text	K. A. Merchant & W. A. Van der Stede (2017), <i>Management Control Systems: Performance Measurement, Evaluation, and Incentives</i> . London: Financial Times/Prentice-Hall, 4th edition.

Course Objectives

This course is designed to broaden and deepen your conceptual and technical understanding of accounting as it is used for management purposes. The emphasis in the course is on *financial controls*, which dominate in importance at managerial levels in all but the smallest organizations. Using financial controls requires managers to make decisions about: (1) responsibility structures (e.g., cost centers, profit centers), (2) performance measures (e.g., market, financial, and/or nonfinancial measures and their combinations), (3) performance evaluations, which take into consideration performance targets or other benchmarks, and (4) rewards (including performance-dependent compensation). The course is issue-oriented, with current and emerging issues as a major focus.

The course is built around a textbook—Merchant and Van der Stede's *Management Control Systems*. The text will be supplemented with some additional materials that will be distributed via Blackboard.

The focus of most of the classes will be on a case that brings the topics “to life” and provides issues for us to discuss. The readings are intended to provide background that is useful for informing the case discussions. For each case, I will provide some Discussion Questions. These questions are intended to help frame and focus your reading and consideration of the course materials.

The cases require advance preparation and thought. I encourage you to prepare the cases in a study group. Much of the learning comes from sharing and discussing your ideas with your peers.

Grading

In-class quizzes	50 points
E-mail questions and class participation	50 points
Final exam	<u>100 points</u>
<i>Total</i>	<i>200 points</i>

The **quizzes** will be given in a few classes on an unannounced basis. As protection against the possibility of a bad day or an unlucky absence, in computing my course grades I will disregard the lowest quiz score.

On the bottom of many of the class assignments, you will see that I have included an “**e-mail question**.” Prior to noon before our class pertaining to that assignment, please send me an e-mail message answering the question(s) for that day's class. This is not intended to be a time-consuming obligation. Your answers should be brief—**three sentences or less** for each question.

Your answers to the e-mail questions serve multiple purposes. First, they help me to get to know you and to see how you think. Second, these messages open the communication channels between us. Since you have to send me a message, it is easy to append another thought. In the past, some students have used this opportunity to ask a question on another topic or to give me some feedback about the course. I welcome this. I might also respond immediately to your e-mail question answer. Third, your e-mail answers help me orient the class discussion. For example, they help me both to judge the mindset of the class and to find people with unique perspectives. Finally, the questions are functional because they encourage good advance preparation. The regularity with which you input your e-mail question answers on a timely basis and the quality of your answers will form part of your participation grade.

I assign a material proportion of the grade based on **class participation**. I do this for several reasons. First, it improves my grading accuracy. I think I can learn more from hearing you share your ideas in a long series of classes than I can from reading what you write in a short exam session. I keep track of participation in every class.

But perhaps more important than that, grading class participation motivates class participation, and having highly interactive class sessions helps the learning process. Active class participation encourages students to be well prepared and thus to become active, rather than

passive, learners. Participation provides students with the opportunity to gain from the experiences and talents of everyone in the class. Moreover, class participation helps students improve their oral communication skills. This is important because research shows that people in the business world tend to spend very little time reading and even less time writing reports. A great deal of managers' and other professionals' interactions with others are through oral communication.

Class participation evaluations will be based primarily on the quality of the participation in classroom discussions. To be clear on what I am looking for regarding class participation, and to further aid in your preparation, I have listed below some characteristics of effective class participation:

- (1) Does the student make points that are especially pertinent to the discussion? Do they increase the understanding of the class or are they simply a regurgitation of the problem or case facts?
- (2) Is there continuity in one's contribution from what has been said previously during class, or are the comments disjointed, isolated, or tangential? The best class contributions are those that reflect not only excellent preparation, but also good listening, interpretive, and integrative skills.
- (3) Do the comments reflect a willingness to put forth new, challenging ideas or are they always agreeable and "safe"?
- (4) Is the participant able and willing to interact with others by asking questions, providing supportive comments, or challenging **constructively** what has been said?

Your participation will be evaluated based on a near-continuous scale, the end points of which can be described as follows:

Outstanding Contributor: This person's contributions reflect exceptional preparation, and the ideas offered are always substantive and provide major insights and direction for the class. If this person were not a member of the class, the quality of the discussions would be diminished significantly.

Unsatisfactory Contributor: This person may be absent from class or someone who rarely participates in class discussion. Alternatively, this person's contribution in class reflects inadequate preparation and/or understanding. Ideas offered are not substantive and provide few, if any, insights and never a constructive direction for the class. Integrative comments and effective arguments are absent. Class comments are either obvious, isolated from the main discussion, or confusing to the class.

The **final exam** will be a take-home exam, likely a case or two. You can take this exam as an individual or as a group. The groups can be as large as four people. In the middle of the course, I will ask you to tell me if you will be taking the exam as an individual or in a group, and if in a group, who is included in your group. The answers to the final exam must be deposited in my mailbox in the lobby of the School of Accounting Building by the deadline.

Schedule of Classes

Session 1

Topic: Performance Measurement and the Control Function of Management

In this first class, we will go over the syllabus and get to know each other. Then I will provide a general lecture on management controls and the control uses of performance measures that we will focus on in this course. Finally, we will discuss a short case that will set the stage for our further discussions.

Reading: MV, Chapter 1

Session 2

Topic: Results Controls

In this class, we will examine and critique the performance measurement and incentive system used in a business with which all of you have some familiarity—automobile retailing. The company is privately held, and it makes use of some “nonfinancial” performance measures. In the case, we see a simple use of transfer pricing. We will examine incentives at and below management levels of the organization. Moreover, we see some evidence of people “playing games” with the measures. Understanding the causes, consequences and remedies of game playing is a recurring theme in this course.

Reading: MV, Chapters 2 and 9

Prepare for Class: Case—Puente Hills Toyota

Assignment Question:

Evaluate the performance measurement and incentive systems used at Puente Hills Toyota. What changes would you recommend, if any?

E-mail Question:

As a first approximation, which of the following statements do you believe is most correct, and why:

- I. People are people. They respond approximately equally to many things, including pay-for-performance systems.
- II. To work well, management and incentive systems must be tailored to fit the specific employee group (e.g., nationality, role, age, and gender).

Session 3

Topic: Financial Responsibility Structures

The focus of this session is on one of the main management control system choices—design of the organization's authority and financial responsibility structures.

Reading: MV, Chapter 7

Prepare for Class: Case—Kranworth Chair Corporation (KCC)

Assignment Questions:

1. Identify the most important key recurring decisions that must be made effectively for KCC to be successful. In KCC's functional organization, who had the authority to make these decisions? Who has the authority to make these decisions in KCC's new divisionalized organization?
2. Did KCC's top management go too far in decentralizing the corporation? Did they not go far enough? Or did they get it just right? Why?
3. Evaluate KCC's new performance measurement and incentive system. Assuming that KCC will retain its new divisionalized organization structure, what changes would you recommend, if any? Why?
4. Assume that the R&D function is to be decentralized (given to the divisions). Would this necessitate changes to KCC's performance measurement and incentive system? If so, which and why? If not, why not?

E-mail Question:

The vast majority of corporations are decentralized to a considerable degree. What kinds of organizations are best run in a largely *centralized* manner, and why?

Session 4

Topic: Planning and Budgeting

Most firms beyond minimal size, but not all, engage in often extensive planning processes, the annual component of which is called budgeting. The Mainfreight case that we will discuss in this session, however, illustrates the functioning of a large, successful international logistics company that does *not* engage in an annual budgeting process. The goal in this case is to think about what budgeting is, and what it is not, and how Mainfreight can succeed without having a budget, which is a control system element that most companies think is essential. One of the key points of discussion of this session, therefore, is to consider whether there are valid, effective alternatives to budget-based performance management systems, and if so, whether these really are what they claim to be or just budgeting processes under a different guise?

Reading: MV, Chapter 8, and Chapter 3

Prepare for Class: Case—Mainfreight

Assignment Questions:

1. At the very least, Mainfreight's management systems are nontraditional.
 - a. What are the key elements of Mainfreight's results control systems?
 - b. Why did Mainfreight managers decide to take a nontraditional approach?
 - c. How does Mainfreight perform the functions typically fulfilled by budgets? Or are some of those functions really not that important?
 - d. Does the Mainfreight system address the limitations of traditional budgets? Does it introduce new limitations?
2. Is Mainfreight a well-controlled organization?
3. Should companies that now use an annual budgeting process try to emulate some or all of the management systems used by Mainfreight? Why or why not?

E-mail Question:

Mainfreight's top executives, three of whom are qualified accountants, maintain that their company does not prepare budgets. Is that contention accurate? How should one determine whether a company prepares a budget or not?

Session 5

Topic: Performance Measures

Today's discussion focuses on a company that does not place much emphasis on financial measures of performance. Why? What do they do instead?

Reading: MV, Chapters 10 and 11

Prepare for Class: Case—Catalytic Solutions, Inc.

Assignment Question:

Evaluate the CSI performance measurement and compensation systems. What changes would you suggest be made, if any? Explain.

E-mail Question:

Fast forward 10 years. Assume that CSI has been successful. It is now a much larger, public company. It has three operating divisions (investment centers) that focus on different markets. Would you expect the CSI measurement and compensation system to be different at that time? If so, how and why? If not, why not?

Session 6

Topic: Performance evaluations

In this class, we will continue our discussion of performance evaluations. How can/should firms deal with the effects of uncontrollable events that often obscure managers' impacts on performance measures?

Reading: MV, Chapter 12

Prepare for Class: Case 1—Olympic Car Wash

Assignment Question:

How large should the bonus pool be for the Aalst location?

Prepare for Class: Case 2—Beifang Chuang Ye Vehicle Group

Assignment Question:

To what extent, if at all, should Mr. Zhou provide incentive compensation for his employees when his company is losing money? Why? What factors did you take into consideration in making your judgment?

E-mail Question:

Some companies make performance evaluation and bonus adjustments to protect managers from the harmful effects of many uncontrollable factors. Other companies make no such adjustments. Is one of these approaches clearly inferior, or is this just a “management style” choice?

Session 7

Topic: Enterprise Risk Management

Our focus in this session is on enterprise risk management, a newly developing tool aimed at helping companies address all the various kinds of risks they might face.

Prepare for Class: Case—Entropic Communications, Inc.

Assignment Questions:

1. Why did Entropic implement a formal enterprise risk management (ERM) process?
2. Do you think the company realized the benefits of ERM as envisioned by COSO? Why or why not?
3. What changes would you suggest for making the ERM process at Entropic more effective?

E-mail Question:

ERM is currently one of the hottest topics being written about in management, accounting, and corporate governance practitioner journals. Virtually every company is looking at the technique

and deciding whether and how to use it. Do you think the ERM technique is a fad that will soon disappear or an improvement that will provide enduring benefits to a broad range of companies?

Session 8

Topic: Management Control Impacts of the Sarbanes-Oxley Act

In this session we will focus on the benefits and costs the Sarbanes-Oxley Act (SOX) from the corporate perspective.

Reading: MV, Chapter 13

Prepare for Class: Case—Pacific Sunwear of California, Inc.

Assignment Questions:

1. Evaluate the process that PacSun went through to comply with SOX, and particularly SOX Section 404. Was that process as effective and efficient as it could have been?
2. Are the “significant deficiencies” that were identified in each of the two years of the audit evidence of control system flaws or largely irrelevant technical violations? Another way to phrase this question might be: Should disclosure of these deficiencies have had a negative effect on PacSun’s stock price?
3. PacSun executives seem convinced that the costs of complying with SOX were greater than the benefits to the company. Why did PacSun not benefit from the compliance process to the same extent as some other companies? Or were their compliance costs just too high?

E-mail Question:

Judging now with some benefits of hindsight, was SOX a good law?

Session 9

Topic: Earnings Management and the Roles of Controllers and CFOs

In this session, we will examine some of the important roles that controllers and CFOs play in their organizations, particularly in times of stress.

Reading: MV, Chapter 14

Prepare for Class: Case—Don Russell: Experiences of a Controller/CFO

Assignment Questions:

1. Was Don Russell a good controller for Cook and Spector, Inc.? Why or why not?
2. Does Don have the power to force ETI top management to make a correcting accounting entry? If not, what should he do? If so, should he force the entry to be made, and how large should it be?

3. Are earnings management practices such as took place at C&S and ETI smart? Are they ethical?
4. Does Don Russell have an obligation greater than that of other employees to try to ensure that his corporation acts ethically?

E-mail Question:

All things considered, was Don Russell a good controller for Cook and Spector, Inc.? Did he deserve hearty congratulations and a nice bonus or a boot out the door? Explain briefly.

Session 10

Topic: Corporate Governance and the Roles of Boards of Directors

In this class, we will focus broadly on systems of corporate governance and the roles and obligations of boards of directors.

Reading: MV, Chapter 13 (already assigned for Session 9)

Prepare for Class: Case—Arrow Motorcar Corporation

Assignment Questions:

1. Why did Arrow Motorcar Corporation have a board of directors before it went public? How (if at all) do the legal and moral obligations of private-company directors differ from those of directors of publicly-held companies?
2. Evaluate the board composition and actions. All things considered, did the board act properly? Did the board members choose the optimal time to terminate Billy Ray Repko?
3. What should the board members do now (March 22, 2016)?
4. What could have prevented or minimized the problems that Arrow faced?

E-mail Question:

If the Sarbanes-Oxley law had been passed before the time of this case, do you think the problems faced by the board of Arrow Motorcar Corporation would have occurred? Explain.

Session 11

Topic: Industry application: A Sales Incentive System

Managers at Office Solutions, Inc., are considering a significant change in the compensation plan for some of the company's sales representatives. Are they on the right track? Can we give them suggestions for improvement of their ideas? I expect that the key managers at Office Solutions will be in our class to listen to our suggestions and to engage in an active discussion with the class.

Prepare for Class: Case—Office Solutions, Inc.

Assignment Questions:

1. Evaluate the new approach for compensating the sales representatives at Office Solutions. In your critique, consider, at a minimum:
 - The recognition of the two different types of representatives;
 - The performance measures;
 - The performance standards;
 - The forms, mixes and amounts of compensation.
2. Why are at least some of the representatives resistant to the change? How should that resistance be addressed?
3. Would Office Solutions be better off if all of its sales representatives were good at “hunting”? If so, how should the company move in that direction?

E-mail Question:

Bob Mairena has realized that most of his older sales representatives, those over the age of 50, are not good at generating new accounts (p. 6 in the case). Is this problem fixable, maybe through the compensation system, or should the company somehow find a way to employ only young reps? If the latter, how might that be accomplished?

Session 12

Topic: Industry Application: A “billings scorecard”

In this class, we will discuss an innovative results-control approach to solution of a problem that is usually addressed with development and enforcement of sets of policies and procedures.

Reading: MV, Chapter 6

Prepare for Class: Case—Game Shop, Inc.

Assignment Questions:

1. Why was GSI’s production quality control performance so much better than its billing performance?
2. Evaluate the billing improvement effort and each of the elements of the system that emerged. Comment specifically on the billing scorecard, detention meetings, P-CARs, and any other system elements that you believe are relevant.
 - a. In considering the scorecard, be sure to address the following questions: What are the Scorecard and each of its measures trying to accomplish? Are these the right measures? Does each measure add unique value? Are the measures weighted appropriately in importance? Are the business unit grades generally consistent across measures? Can any of the measures be distorted or gamed?

- b. Do you believe that David's improvement efforts will close the gap between production and billing performance enough to meet project goals? Explain?
 - c. Do you have any suggestions to improve the billing process? Explain.
3. GSI's ultimate goal is "perfection." Can this system be used to achieve billing perfection as it is designed, or will changes have to be made, or might even a totally different approach be necessary? Explain.
4. The Billing Scorecard is a results-accountability approach to address the problem, chosen because this company's culture is "metrics centric." What are the advantages and disadvantages of using a results-accountability approach? What other alternatives might have been used to solve the problem?

E-mail Question:

Would you include billing performance among a short list of "critical success factors" for GSI? If so, why has it apparently not received much attention from management up until now? If not, why all the concern now?

Session 13

Topic: Industry application: A bank

In this session, we will focus on the performance measurement/management control challenges in the wholesale banking industry.

Reading: MV, Chapters 4, 5

Prepare for Class: Case—Haengbok Bancorp

Assignment Questions:

1. Evaluate Haengbok Bancorp's system of controlling the behaviors of the account managers in the Los Angeles branch. What changes would you suggest be made, if any? Explain. In your answer, comment specifically on the merits and demerits of the control philosophy and each of the significant individual control system elements, such as the use of mini profit centers and the associated performance measures and incentives.
2. Discuss the FETC loan application situation and the effects that outcome might have on the account managers' behaviors and performances? Does this example illustrate a problem that needs to be fixed? If not, why not? If so, how would you fix it? Explain.

E-mail Question:

Are any of the issues in this case or their preferred solutions affected in any way by the fact that the bank and its managers are Korean, rather than, say, American, French, or Chinese?

Session 14

Topic: Industry Application: A Hedge Fund

In this class, we will discuss issues related to performance evaluation and incentive compensation in a hedge fund. Our primary focus will be on the role of the hedge fund analysts.

Prepare for Class: Case—Raven Capital, LLC

Assignment Questions:

1. Assume the role of a Raven portfolio manager who has to allocate a bonus pool to the four analysts working primarily for him. Assume a 20% incentive fee for Raven. Use 30% of the incentive fee as the bonus pool to be allocated to the four analysts whose backgrounds and 2009 portfolio performances are described in Assignment Figures A and B (posted separately on Blackboard).
 - a. How would you allocate bonuses to these four analysts? What alternatives did you consider? Why did you make the choices you did?
 - b. Is there any other information you would like to have had available before making your decisions? If so, which?
 - c. Do you think you should pay out the entire bonus pool this year, or hold some money in a “bonus bank reserve”? Why or why not?
 - d. Should the proportions of the bonuses allocated vary depending on the size of the bonus pool available? Redo the allocations of the bonus pool to these four analysts assuming that because of a high water mark constraint, the incentive fees earned in 2009 were only \$300,000.
2. Evaluate the Raven performance evaluation and incentive compensation system. What changes would you recommend, if any?

E-mail Question:

What could Raven management do to make it possible to evaluate the analysts' performances more objectively? Should they make these changes?

After we discuss this case, I will provide a brief review of the major themes of the course and will hand out the final exam. It will be a take-home exam that is due in my mailbox, in the lobby of the Accounting building, by 5:00 p.m. on Thursday next week. You can work on the exam only in the group to which we agree you have been assigned.

Model Syllabus 2

London School of Economics

Department of Accounting

AC310

Advanced Managerial Accounting

Module 1

Michaelmas Term (Weeks 1–5)

**Management Accounting in its Organizational Context:
The Function of Management Control Systems**

Professor Wim A. Van der Stede

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Tel. 020 7955 6695

Introduction

Module 1 of AC310 is focused on the study of the quintessential role of management control in decentralized organizations. Our focus will be on the measurement and evaluation of the performances of organizational entities and their managers. Management accounting at this level of analysis is an integral part of companies' *management control systems*.

In this module, we will discuss what it means to have an organization be “in control,” what alternatives managers have for ensuring good control, and how managers should choose from among control system alternatives. Then we will focus on each of the elements of “financial control systems,” which provide the dominant form of control in the vast majority of decentralized organizations. These elements include financial target setting (as part of organizations' planning and budgeting processes), performance measurement and evaluation, and the assignment of various forms of organizational rewards, such as bonuses and promotions.

This module is intended as an introduction for individuals who will make business decisions, evaluate organizational performance, or evaluate others (and/or be evaluated) through the use of financial and nonfinancial information. In other words, the module is designed to be useful particularly for those who aspire to be managers, management consultants, or specialists in staff functions such as controllers, financial analysts, auditors, and human resource specialists.

Teaching Format

This module is taught as five lectures and five classes, and the materials in this module will be presented through both lectures and case study analyses. The case studies permit the exploration of management control issues in a broad range of settings (e.g., large and small firms, manufacturing and service firms, multinational firms, start-ups). Moreover, the foundational theories for the topics in this module have been introduced in AC211. An important objective of this module is, therefore, (1) to expand that knowledge through further study, and (2) to apply that knowledge to cases.

The case method of instruction, however, requires good advance preparation by the students. For the cases that we discuss in *class* settings, I expect *every* student to actively participate in the case analysis and discussion. Although during *lectures* not every student will have an opportunity to contribute to the discussion, I still expect active participation when I pose questions or solicit input from the students.

Course Materials

Merchant, Kenneth A., and Wim A. Van der Stede (2017), *Management Control Systems: Performance Measurement, Evaluation, and Incentives* (Prentice-Hall/Financial Times), 4th Edition. (Referred to as **MCS** in the schedule below.)

Some additional materials are distributed separately in the **course pack**.

Written Work

You are expected to hand in one essay for this module drawn from the list of “essay questions” listed throughout the schedule below. Because each essay question is related to a case study, you must turn in your essay of choice *at the beginning* of the session in which the case is discussed. An essay that is handed in after the case has been discussed in class will not be marked.

Assessment

Assessment will be based wholly upon a 3-hour written examination during the Summer Term covering exam questions from across all four modules of this course. Past examination papers are available on the Library’s website.

Module Schedule

Week 1—The Control Function of Management

Lecture 1: MCS Chapters 1–6

Class 1: *Puente Hills Toyota*

Case Questions (for advance preparation):

1. Evaluate the performance measurement and incentive systems in use at Puente Hills Toyota in terms of their overall effectiveness as a “results control” system.
2. Elaborate specifically on the specific features of the results control system in place at Puente Hills Toyota—strengths and weaknesses?
3. What factors are critical for Puente Hills Toyota’s success? What changes would you recommend, if any?

Essay Question (for written work): Considering that Puente Hills Toyota’s is probably quite a “typical” incentive system one might find in customer-driven, sales-focused organizations (in the United States), please comment on the following statement:

People are people and they respond equally to many things, including pay-for-performance systems, and thus incentive systems will work well anywhere and in any organization.

Week 2—Results Accountability

Lecture 2: MCS Chapter 7

Class 2: *Kranworth Chair Corporation*

Case Questions (for advance preparation):

1. Identify the most important key recurring decisions that must be made effectively for Kranworth Chair Corporation (KCC) to be successful. In KCC’s functional organization, who had the authority to make these decisions? Who has the authority to make these decisions in KCC’s new divisionalized organization?
2. Did KCC top management go too far in decentralizing the corporation? Did they not go far enough? Or did they get it just right? Why?
3. Evaluate KCC’s new performance measurement and incentive system. Assuming that KCC will retain its new divisionalized organization structure, what changes would you recommend, if any? Why?

Week 3—Planning and Budgeting

Lecture 3: MCS Chapter 8; and,

Hansen, Stephen C., David T. Otley, & Wim A. Van der Stede (2003). Recent Developments in Budgeting: An Overview and Research Perspective. *Journal of Management Accounting Research* 15, pp. 95–116.

Class 3: *Mainfreight*

Case Question (for advance preparation),

1. At the very least, Mainfreight's management systems are nontraditional.
 - a. What are the key elements of Mainfreight's results control systems?
 - b. Why did Mainfreight managers decide to take a nontraditional approach?
 - c. How does Mainfreight perform the functions typically fulfilled by budgets? Or are some of those functions really not that important?
 - d. Does the Mainfreight system address the limitations of traditional budgets? Does it introduce new limitations?
2. Is Mainfreight a well-controlled organization?
3. Should companies that now use an annual budgeting process try to emulate some or all of the management systems used by Mainfreight? Why or why not?

Essay Question (for written work): Mainfreight's top executives, three of whom are qualified accountants, maintain that their company does not prepare budgets. Is that contention accurate? How should one determine whether a company prepares a budget or not?

Week 4—Performance Measurement

Lecture 4: MCS Chapters 10–12; and,

Kaplan Robert S. & David Norton (2005), The Balanced Scorecard: Measures that Drive Performance, *Harvard Business Review*, July-August, pp. 172–180.

Ittner, Christopher D., & David F. Larcker (2003), Coming up Short on Nonfinancial Performance Measurement, *Harvard Business Review*, November, pp. 88–95.

Class 4: *Catalytic Solutions, Inc.*

Case Questions (for advance preparation):

1. Evaluate the composition of the compensation package at CSI.
 - a. What are the advantages and disadvantages of awarding stock options?
 - b. What are the advantages and disadvantages of awarding bonuses?
 - c. Was the relative importance placed on salaries, stock options, and bonus awards reasonable? Why should CSI offer a mix of rewards rather than providing its employees 100% of their compensation based on 100% salary? On 100% annual bonuses?
2. Evaluate the specific features of the annual bonus plan in 2001 and 2002. Comment on:
 - a. the choice of the number of measures used, the specific measures used, and the changes in the plan between years;
 - b. the relative proportions of financial vs. nonfinancial measures;
 - c. the decision to base rewards on company-wide, rather than individual, performance;

- d. the amount of subjectivity allowed in determining the bonus awards;
- e. the calibration (target difficulty) of the bonus plans.

Essay Question (for written work): Fast-forward 10 years. Assume that CSI has been successful. It is now a much larger, public company. It has three operating divisions (investment centers) that focus on different markets. What would you expect the CSI measurement and compensation systems to look like at that time? Why?

Week 5—Incentive Systems

Lecture 5: MCS Chapter 9; and,

Van der Stede, Wim A. (2007), The Pitfalls of Pay-for-Performance, *Finance & Management*, 150, December, 10–13.

Van der Stede, Wim A. (2009), Designing Effective Reward Systems, *Finance & Management*, 168, October, 6–9.

Class 5: *Houston Fearless 76, Inc.*

Case Questions (for advance preparation):

1. Why are Houston Fearless 76, Inc. (HF76) managers unhappy with the company's existing sales incentive plan? Are weaknesses in this plan a major cause of the company's performance problems?
2. Evaluate the new incentive plan being contemplated. What modifications would you make to the proposed new plan, if any? How would you address the unresolved issues?
3. Are there any significant impediments to the successful implementation of the new incentive plan? If so, which?
4. Would you make any changes to the system providing bonuses to sales assistants? If so, which?

Model Syllabus 3

Accounting 537—Management Control Systems

Marshall School of Business, University of Southern California

Professor	Kenneth A. Merchant
Office	HOH 606
Telephone	(213) 821-5920
E-mail	kmerchant@marshall.usc.edu
Class Hours	Tue/Thu 12:30–1:50 p.m.
Classroom	JKP 202
Office Hours	By appointment. Arrange by e-mail. I will do my best to accommodate your schedule.
Honor Code	Students are expected to adhere to, and will be bound by, the University and School policies governing academic integrity.
Text	K. A. Merchant & W. A. Van der Stede (2017), <i>Management Control Systems: Performance Measurement, Evaluation, and Incentives</i> . London: Financial Times/Prentice-Hall, 4th edition.

Course Objectives

Firms' performance evaluation and incentive systems require managers to make many choices. They must design responsibility structures. If performance is defined in accounting terms, as is common at managerial levels of the firm, these structures are composed of configurations of cost centers, revenue centers, profit centers, and investment centers. They have to choose specific performance measures and make them operational. Just within the category of accounting-based measures, which are in common use, are measures with acronyms such as EBITDA, ROE, RONA, ROCE, ROI, RAROC, and RI. And, of course, many market-based and nonfinancial measures are also used frequently. Managers must select measurement windows (e.g., month, quarter, annual, multi-year) for any of the measures chosen. And they have to define the links between the measured performance and various forms of organizational rewards and punishments. Unless all of these choices are made well, problems can result. These systems can frustrate and demotivate employees or, worse, actually encourage them to do the wrong things.

This course presents knowledge of these “results-accountability” systems, with current practice and emerging issues as a major focus. Among the issues, we will discuss the advantages and disadvantages of traditional financial measures and nontraditional measures

such as EVA, EBITDA, and “pro-forma” earnings, as well as nonfinancial measures (e.g., customer satisfaction) and combinations found in dashboards and balanced scorecards. We will also discuss incentives-related topics, such as “stress-testing” and resource allocation uses of financial plans, the “beyond budgeting” movement, performance assessment by internal and operational auditors, and management implications of the Sarbanes-Oxley Act and the still-developing enterprise risk management (ERM) techniques.

The focus of most of the classes will be on discussions of specific cases developed from real-world practice. The assigned readings are intended to provide background that is useful for informing the case discussions. For each case assignment, I provide some Discussion Questions. These questions are intended to help frame and focus your reading and consideration of the course materials. In a number of the classes, I will invite a practitioner visitor to class both to add expertise and to “bring the topics to life.”

The course is built around a textbook—Merchant and Van der Stede’s *Management Control Systems*. The text is supplemented with a short monograph (de Kluyver’s *A Primer on Corporate Governance*):

(MV) K. A. Merchant & W. A. Van der Stede (2017), *Management Control Systems* (London: Financial Times/Prentice-Hall), 4th edition.

(deK) C. de Kluyver (2009), *A Primer on Corporate Governance* (New York: Business Expert Press).

Some additional materials also will be distributed on Blackboard.

Grading

Quizzes	40 points
Project 1	40 points
Project 2	40 points
Project 3	40 points
Class participation	40 points
Final exam	<u>100 points</u>
<i>Total</i>	<i>300 points</i>

Quizzes and Exams

The quizzes and the final exam will test **individual** (not group) work. The **quizzes** will focus on specific issues in the case being discussed that day in class. The **final exam**, will be a take-home exam in lieu of an exam during the final exam period. It will involve a case analysis. No make-up exams will be given (see LSOA policy on incompletes).

Projects

The projects will involve group analyses of cases that are supported by data provided on Excel spreadsheets. The first project is a capital budgeting exercise. The second is a budget “stress testing” exercise. The third involves comparative performance evaluations of a large number of bank branches. Some groups will be asked to present their analyses and conclusions in class.

Students can form their own working groups, but I will help if needed. The optimum (and maximum) group size is four. I will accept groups as small as three. As part of the grading process, I will ask students to grade each of their fellow group members. This is done to try to reduce the “free-rider” effect.

Class Participation

I assign a material proportion of the grade based on **class participation** for several reasons. First, it improves my grading accuracy. I think I can learn more from hearing you share your ideas in a long series of classes than I can from reading what you write in a few short exam sessions.

But perhaps more important than that, grading class participation motivates class participation, and having highly interactive class sessions helps the learning process. Active class participation encourages students to be well prepared and thus to become active, rather than passive, learners. Participation provides students with the opportunity to gain from the experiences and talents of everyone in the class. And class participation helps students improve their oral communication skills. This is important because research shows that people in business tend to spend very little time reading and even less time writing reports. A great deal of managers’ and other professionals’ interactions with others are through oral communication.

Class participation evaluation will be based primarily on the quality of the participation in classroom discussions. To be clear on what I am looking for regarding class participation, and to further aid in your preparation, I have listed below some characteristics of effective class participation:

- (1) Does the class member make points that are especially pertinent to the discussion? Do they increase the understanding of the class or are they simply a regurgitation of the problem or case facts?
- (2) Is there continuity in one’s contribution from what has been said previously during class, or are the comments disjointed, isolated, or tangential? The best class contributions are those that reflect not only excellent preparation, but also good listening, interpretive and integrative skills.
- (3) Do the comments reflect a willingness to put forth new, challenging ideas or are they always agreeable and “safe”?
- (4) Is the participant able and willing to interact with others by asking questions, providing supportive comments or challenging **constructively** what has been said?

Participation will be evaluated based on a near-continuous scale, the end points of which can be described as follows:

Outstanding Contributor: This person's contributions reflect exceptional preparation, and the ideas offered are always substantive and provide major insights and direction for the class. If this person were not a member of the class, the quality of the discussions would be diminished significantly.

Unsatisfactory Contributor: This person may be absent from class or someone who rarely participates in class discussion. Alternatively, this person's contribution in class reflects inadequate preparation and/or understanding. Ideas offered are not substantive and provide few, if any, insights and never a constructive direction for the class. Integrative comments and effective arguments are absent. Class comments are either obvious, isolated from the main discussion, or confusing to the class.

E-Mail Questions

On the bottom of many of the class assignments, you will see that I have included an "e-mail question." Prior to noon before each of our classes, please send me an e-mail message or private Blackboard posting answering the question(s) for that day's class. This is not intended to be a time-consuming obligation. Your answers should be brief—**three sentences or less** for each question.

Your answers to the e-mail questions serve multiple purposes. First, they help me to get to know you and how you think. Second, these messages open the communication channels between us. Since you have to send me a message, it is easy to append another thought. In the past some students have used this opportunity to ask a question on another topic or to give me some feedback about the course. I welcome this. Third, your e-mail answers help me orient the class discussion. For example, they help me both to judge the mindset of the class and to find people with unique perspectives. Finally, the questions are functional because they encourage good advance preparation. The regularity with which you input your e-mail question answers on a timely basis and the quality of your answers will form part of your participation grade.

Schedule of Classes

Session 1

Topic: The Control Function of Management

In this first session, we will go over the syllabus and get to know each other. Then I will provide a general lecture on managers' control options. Finally, we will discuss a control vignette.

Reading: MV, Chapters 1–4

Session 2

Topic: Control System Alternatives and What Can Go Wrong

No MCS is perfect. Some controls fail, and others cost more than the benefits they provide. Today we will examine a company that suffered significant problems. Could they have been prevented? If so, how?

Reading: MV, Chapter 5

Prepare for Class: Case—Atlanta Home Loan

Assignment Questions:

1. Identify the devices (controls) that Al Fiorini used to control his business both before and after he went back to school. Classify each control as a results, action, or personnel or cultural type of control.
2. What went wrong? Did Al use the wrong types of controls? Did he use the right types of controls but fail to design or implement them properly? Or was he just unlucky?

E-mail Question:

What should Al Fiorini do now? Why?

Session 3

Topic: Evaluating Control System Alternatives

Today's case illustrates the control system used in a field service engineer (FSE) setting. The case is particularly interesting because the company, Diagnostic Products Corporation (DPC), is in the midst of a significant change. Formerly, company managers controlled FSE inputs—they paid FSEs for hours worked. Now they are attempting to measure FSE outputs, or results, and to provide performance-dependent compensation.

Reading: MV, Chapter 6

Prepare for Class: Case—Diagnostic Products Corporation (DPC)

Assignment Question:

Evaluate the design of the DPC Performance Bonus Program for U.S.-based field service engineers (FSEs) as it currently exists and the way in which the Program is being implemented. What changes would you suggest, if any?

E-mail Question:

Instead of using a results-control system like the Performance Bonus Program could DPC control its U.S.-based FSEs effectively using only action and/or personnel/cultural controls?

Session 4

Topic: Financial Responsibility Structures

The focus of this session is on one of the main management control system choices—design of the organization's authority and financial responsibility structures.

Reading: MV, Chapter 7

Prepare for Class: Case—Kranworth Chair Corporation

Assignment Questions:

1. Identify the most important key recurring decisions that must be made effectively for KCC to be successful. In KCC's functional organization, who had the authority to make these decisions? Who has the authority to make these decisions in KCC's new divisionalized organization?
2. Did KCC top management go too far in decentralizing the corporation? Did they not go far enough? Or did they get it just right? Why?
3. Evaluate KCC's new performance measurement and incentive system. Assuming that KCC will retain its new divisionalized organization structure, what changes would you recommend, if any? Why?
4. Assume that the R&D function is to be decentralized (given to the divisions). Would this necessitate changes to KCC's performance measurement and incentive system? If so, which and why? If not, why not?

E-mail Question:

The vast majority of corporations are decentralized to a considerable degree. What kinds of organizations are best run in a largely *centralized* manner, and why?

Session 5

Topic: Interdependence and the Transfer Pricing Problem

Where products or services are provided by one organizational entity to another, difficult cost allocation or transfer pricing problems often follow. In this session, we will discuss a representative example.

Prepare for Class: Case—Zumwald AG

Assignment Questions:

1. What sourcing decision for the X73 materials is in the best interest of:
 - a. The Imaging Systems Division?

- b. The Heidelberg Division?
 - c. The Electronic Components Division?
 - d. Zumwald AG?
2. What should Mr. Fettingner do?

E-mail Question:

Is a transfer price just a cost allocation with a profit margin tacked onto it? Explain.

Session 6

Topic: Planning and Budgeting

Most firms beyond minimal size, but not all, engage in often extensive planning processes, the annual component of which is called budgeting. The Mainfreight case that we will discuss in this session, however, illustrates the functioning of a large, successful international logistics company that does *not* engage in an annual budgeting process. The goal in this case is to think about what budgeting is, and what it is not, and how Mainfreight can succeed without having a budget, which is a control system element that most companies think is essential. One of the key points of discussion of this session, therefore, is to consider whether there are valid, effective alternatives to budget-based performance management systems, and if so, whether these really are what they claim to be or just budgeting processes under a different guise?

Reading: MV, Chapter 8

Prepare for Class: Case—Mainfreight

Assignment Questions:

1. At the very least, Mainfreight's management systems are nontraditional.
 - a. What are the key elements of Mainfreight's results control systems?
 - b. Why did Mainfreight managers decide to take a nontraditional approach?
 - c. How does Mainfreight perform the functions typically fulfilled by budgets? Or are some of those functions really not that important?
 - d. Does the Mainfreight system address the limitations of traditional budgets? Does it introduce new limitations?
2. Is Mainfreight a well-controlled organization?
3. Should companies that now use an annual budgeting process try to emulate some or all of the management systems used by Mainfreight? Why or why not?

E-mail Question:

Mainfreight's top executives, three of whom are qualified accountants, maintain that their company does not prepare budgets. Is that contention accurate? How should one determine whether a company prepares a budget or not?

Note: The names of the individuals working on the two group projects are due to me by the start of this class. The optimum (and maximum) group size is four. Groups of three are permissible. Please have a representative send me an e-mail message with the names of the individuals in your group.

Session 7

Topic: Business Models and Resource Allocations (Group Project #1)

Many resource allocation decisions are made during companies' planning and budgeting processes. Obviously companies want to make good investments, but is maximizing NPV (or IRR) always the most important decision-making criterion?

Prepare for Class: Case—Vitesse Semiconductor Corporation

Assignment Questions:

The detailed assignment for the Vitesse Semiconductor Corporation case is distributed in the assignments section of Blackboard. For this project you will hand in a report. There will be no in-class group presentations beyond needing to be ready to speak when being called as we discuss the case as usual.

Session 8

Topic: Results Controls (or Not)

In this session, we will examine and critique the performance measurement and incentive systems in two companies in an industry with which all of you have some familiarity—automobile retailing. The two companies' systems are quite different. Can we say which one is the better design?

Reading: MV, Chapter 9

Prepare for Class: Cases—Puente Hills Toyota

Kooistra Autogroep

Assignment Questions:

1. Compare and contrast the performance measurement and incentive systems used at Puente Hills Toyota and Kooistra Autogroep.
2. When comparing the use of incentives in the two companies, do you believe that incentive pay is truly effort-inducing; that is, does it drive employees to perform at their best? If you believe incentive pay is not, in whole or in part, effective in making employees work harder, then what

other potentially useful purposes does variable incentive pay provide for organizations relying on it, if any?

3. What advice would you provide to the managers of these companies?

E-mail Question:

As a first approximation, which of the following statements do you believe is most correct, and why:

- I. People are people. They respond approximately equally to many things, including incentive systems.
- II. To work well, a company's incentive systems must be tailored in many ways to fit the specific desires of various employee groups.

Session 9

Topic: Summary Financial Performance Measures: Advantages and Limitations

There are many forms of summary financial performance measures. Are some better than others?

Reading: MV, Chapter 10

Prepare for Class: Case—Behavioral Implications of Airline Depreciation Accounting Policy Choices

Assignment Questions:

Assume that at least some rewards for the management team (and, hence, also other employees) are based on performance measured in terms of accounting income and returns on net assets. Also assume that all of these airlines are growing; that is, they are adding to their fleet of aircraft.

1. What are the behavioral implications of each of the three depreciation-related accounting policy choices:
 - a. depreciation patterns (i.e., straight-line vs. accelerated);
 - b. estimated useful lives; and
 - c. residual values?

Consider, at a minimum, the effects of each of these choices on decisions regarding:

- a. replacements of aircraft in service;
- b. pricing, assuming that prices are at least somewhat dependent on costs;
- c. evaluations of routes or lines of business;
- d. evaluations of managers, assuming that negotiated budgets provide the primary standards of performance.

2. Assume that in a particular U.S. airline company there is a conflict between the benefits of conservatism vs. liberalism in depreciation accounting. That is, for this company conservatism in depreciation accounting is greatly preferred for financial reporting purposes (for whatever reason) but for internal purposes the company would be better off if the policies were more liberal, or vice versa. Would you recommend to the managers of this company that they adopt a third set of books? That is, should they maintain one set of books for financial accounting purposes, another set for tax purposes, and a third set for the purposes of running the business?
3. If the managers of a particular airline do not want to maintain a third set of books, should they tend to be conservative or liberal in their aircraft depreciation accounting?

E-mail Question:

International Financial Reporting Standards (IFRS) are less prescriptive than current U.S. GAAP, and the interpretive guidance that is provided is more limited. More judgment is needed by managers in firms following IFRS, so this question will become more relevant after U.S. firms shift over to IFRS: Should judgments about financial reporting policies be affected significantly by concerns about the possible effects on behaviors of employees of the firm, or should they be chosen solely based on judgments about what is perceived to provide the best financial reporting disclosures?

Session 10

Topic: New “Improved” Summary Financial Measures of Performance

We will start discussing the performance measurement element of financial control systems. In this session, we will discuss some relatively new financial performance measures that are said to be improved because they provide better indications of value creation. These are essentially modifications of accounting “residual income” that have been given labels with some marketing appeal, such as “economic profit” or “economic value added.”

Prepare for Class: Case—Berkshire Industries, Inc.

Assignment Questions:

1. Were Berkshire’s motivations for a new incentive system reasonable? If so, what were their main options for a new system? Was an economic profit-focused system a reasonable choice?
2. Evaluate the Berkshire Industries’ new incentive plan. What changes would you recommend, if any?
3. What, if anything, should Mr. Embleton do about the problems caused by performance shortfalls in the Spirits Division? Explain.

E-mail Question:

Would an economic profit-based incentive compensation system similar to that used by Berkshire be effective in an Internet start-up company? Why or why not?

Session 11

Topic: Market Measures of Performance

Today our focus is on market measures of performance and, in particular, the incentive effects of stock option grants.

Reading: MV, Chapter 11

Prepare for Class: Case—Superconductor Technologies, Inc.

Assignment Questions:

1. Evaluate the performance measurement and incentive system that STI uses for its top-30 managers. Among the questions you should consider:
 - a. Will the system attract managers' attention and influence behavior in the desired ways?
 - b. Is the system achieving other (nonmotivational) purposes that it is also intended to serve?
 - c. Is each of the elements worth the cost?
 - d. Is the mix of rewards optimal?
 - e. What changes would you recommend, if any?
2. Should the accounting treatment matter? That is should the accounting rule change requiring the immediate expensing of the value of stock options granted (which has now happened) have caused STI to make any changes to its system? If so, which?
3. Will STI have to make changes to its system if and when it expands internationally and employs managers in locations such as London and Shanghai? If so, which?

E-mail Question:

Assume that you, as an STI employee, were awarded options on 100,000 shares of STI stock (symbol: SCON) at market close yesterday at the current market price. Without doing a detailed numerical calculation, what would you estimate the value of that option grant to be for you? (That is, what is the minimum price at which you would be willing to sell the options immediately?) What factors did you consider in making your estimate?

Session 12

Topic: Combinations of Measures: KPIs, Dashboards, and Balanced Scorecards

The focus of this session is on the concurrent use of multiple performance measures. The most popular combination-of-measures system is marketed under the rubric "Balanced Scorecard." But some variations are given alternative names, such as dashboards, KPIs, and performance prisms.

Prepare for Class: Case: Johansen's—The New Scorecard System

Assignment Questions:

1. Why has Johansen's introduced the new scorecard system?
2. What is the company's strategy? What are the key success factors for successfully implementing that strategy? Describe the organizational structure in place at the company.
3. Consider each of the four perspectives of Johansen's new scorecard system. Why are they included? How are they measured?
4. What rating do you advocate awarding Clark? What are the key arguments you use to support that rating?

E-mail Question:

- What kinds of companies should implement a basket-of-measures approach, such as balanced scorecard, rather than just monitoring and rewarding their general managers' performances based on a single bottom-line summary performance measure?

Session 13

Topic: The Planning Role of Budgets: Business Stress Testing (Group Project #2)

As you should know by now, planning is decision-making in advance. Using the financial statement format in a future-looking sense (i.e., budgeting) allows managers to anticipate what might be coming their way in various plausible scenarios.

Case: VisuSon, Inc.

There is no assignment due for this class and, in fact, *we will not meet for this class period*. You can use the time to work on Group Project #2. The assignment is posted on Blackboard. We will hear some of the presentations and will discuss the case in the next class.

Session 14

Topic: The Planning Role of Budgets: Business Stress Testing (cont.)

In this class session, we will consider the work you have done for your first group project. Some of the groups will present their findings. The group presentations will either reinforce each other or, if they are different, we will compare and contrast them.

Case—VisuSon, Inc.

Session 15

Topic: Performance Evaluations: Adjusting for the Effects of “Uncontrollables”

In this class, we will continue our discussion of performance evaluations. How can/should firms deal with the effects of uncontrollable events that often obscure managers' impacts on performance measures?

Reading: MV, Chapter 12

Prepare for Class: Cases—Olympic Car Wash

Beifang Chuang Ye Vehicle Group

Assignment Questions:

For *Olympic Car Wash*:

How large should the bonus pool be for the Aalst location?

For *Beifang Chuang Ye Vehicle Group*:

To what extent, if at all, should Mr. Zhou provide incentive compensation for his employees when his company is losing money? Why? What factors did you take into consideration in making your judgment?

E-mail Question:

Some companies make performance evaluation and bonus adjustments to protect managers from the harmful effects of many uncontrollable factors. Other companies make no such adjustments. Is one of these approaches clearly inferior, or is this just a “management style” choice?

Session 16

Topic: Performance Evaluations (Preparation for Group Project #3)

Class cancelled to allow time to work on Group Project #3.

Session 17

Topic: Performance Evaluations (Presentations of Group Project #3)

In the first part of this session, a few randomly selected groups will present the findings of the performance evaluation group project exercise. The assignment and the *Bank of the Desert* database that go with it are posted on Blackboard. In the last part of the class (I hope), an expert class visitor will provide both some reactions about what he just heard you present and some color about how this real world consulting project unfolded.

Session 18

Topic: Ethical Issues and Analyses and an Industry Application: Retail Brokerage

In this session, we will focus on the management control challenges in the retail brokerage industry. I hope to have an expert guest with us for the class. I have assigned the ethics chapter of the textbook for reading because I want you to be able to identify ethical issues in the cases (and in real life) where they exist. There might be such an issue in the case assigned for this class.

Reading: MV, Chapter 15

Prepare for Class: Case—Philip Anderson

Assignment Questions:

1. What are the proper roles of (a) stock broker and (2) branch manager? That is, what does the company want them to do? What distinguishes someone who is performing well in each of these roles from someone who is not?
2. What control system does Stuart & Co. use to ensure that the brokers and managers perform their roles well? Is it likely to be effective?

E-mail Question:

Do you see any potential ethical issues in this case? If so, what, and how did you identify it as an ethical issue?

Session 19

Topic: The Role of Controller: Issues and Dilemmas

In this session, we will discuss a case that allows us to consider the role of controller/CFO in a more stressful time.

Reading: MV, Chapter 14

Prepare for Class: Case—Don Russell: Experiences of a Controller/CFO

Assignment Questions:

1. Does Don have the power to force ETI top management to make a correcting accounting entry? If not, what should he do? If so, should he force the entry to be made, and how large should it be?
2. Are earnings management practices such as took place at C&S and ETI smart? Are they ethical?
3. Does Don Russell have an obligation greater than that of other employees to try to ensure that his corporation acts ethically?

E-mail Question:

All things considered, was Don Russell a good controller for Cook and Spector, Inc.? Did he deserve hearty congratulations and a nice bonus or a boot out the door? Explain briefly.

Session 20

Topic: Control Impacts of the Sarbanes-Oxley Act

In this session, we will focus on the benefits and costs to corporations of the Sarbanes-Oxley Act (SOX).

Reading: MV, Chapter 13

Prepare for Class: Case—Pacific Sunwear of California, Inc.

Assignment Questions:

1. Evaluate the process that PacSun went through to comply with SOX, and particularly SOX Section 404. Was that process as effective and efficient as it could have been?
2. Are the “significant deficiencies” that were identified in each of the two years of the audit evidence of control system flaws or largely irrelevant technical violations? Another way to phrase this question might be: Should disclosure of these deficiencies have had a negative effect on PacSun’s stock price?
3. PacSun executives seem convinced that the costs of complying with SOX were greater than the benefits to the company. Why did PacSun not benefit from the compliance process to the same extent as some other companies? Or were their compliance costs too high?

E-mail Question:

Judging now with some benefits of hindsight, was SOX a good law?

Session 21

Topic: Corporate Governance and the Roles of Boards of Directors

In this class, we will focus broadly on systems of corporate governance and the roles and obligations of boards of directors.

Reading: deK, Chapters 1–3

Prepare for Class: Case—Arrow Motorcar Corporation

Assignment Questions:

1. Why did Arrow Motorcar Corporation have a board of directors before it went public? How (if at all) do the legal and moral obligations of private-company directors differ from those of directors of publicly held companies?

2. Evaluate the board composition and actions. All things considered, did the board act properly? Did the board members choose the optimal time to terminate Billy Ray Repko?
3. What should the board members do now (March 22, 2016)?
4. What could have prevented or minimized the problems that Arrow faced?

E-mail Question:

If the Sarbanes-Oxley law had been passed before the time of this case, do you think the problems faced by the board of Arrow Motorcar Corporation would have occurred? Explain.

Session 22

Topic: Fiduciary Obligations Related to Executive Compensation and Other Governance Issues

In this class, we will discuss the fiduciary obligations related to executive compensation. Our guest for the day (I hope) will be Michael Ziering, the now-retired Chairman/CEO of Diagnostic Products Corporation (DPC). Michael has both a legal background and experience with issues such as those described in the case assigned for the day. I have asked Michael also to give you some perspective on the Foreign Corrupt Practices Act and the difficulties DPC faced in complying with that Act after we discuss the Golden Parachutes case.

Reading: deK, Chapters 8 and 9

Prepare for Class: Case—Golden Parachutes?

Assignment Questions:

1. If the proposed severance agreement is implemented, who benefits and who loses?
2. Should the compensation committee approve the severance agreement as is? Should some of the elements of the agreement be modified? Or should DTI not have a severance agreement?
3. Suppose that you, as Dennis Feingold, object strongly to at least some of the elements of the severance agreement but that the other two members of the DTI compensation recommend adopting the agreement as it is written. Would it be worthwhile for you to voice your objections forcefully and, perhaps, to take the issue to the full board of directors? Or would you consider it adequate just to cast a negative vote when the issue comes up in the compensation committee?

E-mail Question:

Are there any ethical issues in this case? If so, what? What makes them ethical issues?

Session 23

Topic: “New” practices: Enterprise Risk Management

Our focus in this session is on enterprise risk management, a newly developing tool aimed at helping companies address all the various kinds of risks they might face.

Reading: deK, Chapter 6, particularly pp. 107–108, and Appendix C

Prepare for Class: Case—Entropic Communications, Inc.

Assignment Questions:

1. Why did Entropic implement a formal enterprise risk management (ERM) process?
2. Do you think the company realized the benefits of ERM as envisioned by COSO? Why or why not?
3. What changes would you suggest for making the ERM process at Entropic more effective?

E-mail Question:

ERM is currently one of the hot topics in management. Virtually every company is looking at the technique and deciding whether and how to use it. Do you think the ERM technique is a fad that will soon disappear or an improvement that will provide enduring benefits to a broad range of companies?

Session 24

Topic: “New” practices: Going “Beyond Budgeting”?

In this session, we will examine the “planning and budgeting system” of a company that has gone “Beyond Budgeting.” This approach is still relatively rare. Is it superior to what most companies do and, hence, an innovation that will spread? Or is it a fad that will soon die out?

Reading: Go to the Beyond Budgeting Institute website (www.bbrt.org). Read some of the key materials in the sections titled “About” and “Resources.”

Prepare for Class: Case—Statoil

Assignment Questions:

1. Statoil managers claim that their company no longer prepares a budget. What do they mean by that claim?
2. Why did Statoil decide to abandon budgeting?
3. Describe the new processes that Statoil implemented to replace the budget. What are its strengths and weaknesses?

4. Is the Statoil “Ambition-to-Action” system just a routine implementation of the Beyond Budgeting approach, or does it include some additional features or fail to uphold some of the Beyond Budgeting principles?
5. The “Beyond Budgeting” approach is still relatively rare outside Europe. Why? Is there something about non-European cultures that limits its applicability, or are other companies just slow to catch on to an innovation that has started in Europe?

E-mail Question:

Instead of placing sometimes exclusive emphasis on the achievement of budget targets, as they claim to have done, and possibly still do, in banks, for example, should firms go “beyond budgeting”?

Note: I expect Bjarte Bogsnes, a key character in the Statoil case, to join us in class today. You can see Bjarte’s new book called *Implementing Beyond Budgeting* promoted on the bbrt.org website. Bjarte is Chairman of the Beyond Budgeting Institute in Europe and a leading expert on this topic. We will indeed be fortunate to have him with us in class if he can arrange his travel from Norway.

Session 25

Topic: Industry Application: A Sales Incentive System

In this class, we will discuss the merits and demerits of a proposed new sales incentive system that includes an interesting “truth-inducing” feature.

Prepare for Class: Case—Houston Fearless 76, Inc.

Assignment Questions:

1. Why are Houston Fearless 76, Inc. (HF76) managers unhappy with the company’s existing sales incentive plan? Are weaknesses in this plan a major cause of the company’s performance problems?
2. Evaluate the new incentive plan being contemplated. What modifications would you make to the proposed new plan, if any? How would you address the unresolved issues?
3. Are there any significant impediments to the successful implementation of the new incentive plan? If so, which?
4. Would you make any changes to the system providing bonuses to sales assistants? If so, what?

E-mail Question:

Is extra 5% bonus attached to the “truth-inducing” feature of the proposed new incentive plan large enough to motivate the salespeople to improve the accuracy of their sales forecasts? If not, is this element of performance worth paying out more money?

Session 26

Topic: Industry Application: A Billing Scorecard

In this class, we will discuss an innovative results-control approach to solution of a problem that is usually addressed with development and enforcement of sets of policies and procedures.

Prepare for Class: Case—Game Shop, Inc.

Assignment Questions:

1. Why was GSI's production quality control performance so much better than its billing performance?
2. Evaluate the billing improvement effort and each of the elements of the system that emerged. Comment specifically on the billing scorecard, detention meetings, P-CARs, and any other system elements that you believe are relevant.
 - a. In considering the scorecard, be sure to address the following questions: What are the Scorecard and each of its measures trying to accomplish? Are these the right measures? Does each measure add unique value? Are the measures weighted appropriately in importance? Are the business unit grades generally consistent across measures? Can any of the measures be distorted or gamed?
 - b. Do you believe that David's improvement efforts will close the gap between production and billing performance enough to meet project goals? Explain?
 - c. Do you have any suggestions to improve the billing process? Explain.
3. GSI's ultimate goal is "perfection." Can this system be used to achieve billing perfection as it is designed, or will changes have to be made, or might even a totally different approach be necessary? Explain.
4. The Billing Scorecard is a results-accountability approach to address the problem, chosen because this company's culture is "metrics centric." What are the advantages and disadvantages of using a results-accountability approach? What other alternatives might have been used to solve the problem?

E-mail Question:

Would you include billing performance among a short list of "critical success factors" for GSI? If so, why has it apparently not received much attention from management up until now? If not, why all the concern now?

Session 27

Topic: Industry application: A Hedge fund

In this class, we will discuss issues related to performance evaluation and incentive compensation in a hedge fund. Our primary focus will be on the role of the hedge fund analysts.

Prepare for Class: Case—Raven Capital, LLC

Assignment Questions:

1. Assume the role of a Raven portfolio manager who has to allocate a bonus pool to the four analysts working primarily for him. Assume a 20% incentive fee for Raven. Use 30% of the incentive fee as the bonus pool to be allocated to the four analysts whose backgrounds and 2009 portfolio performances are described in Assignment Figures A and B (posted separately on Blackboard).
 - a. How would you allocate bonuses to these four analysts? What alternatives did you consider? Why did you make the choices you did?
 - b. Is there any other information you would like to have had available before making your decisions? If so, which?
 - c. Do you think you should pay out the entire bonus pool this year, or hold some money in a “bonus bank reserve”? Why or why not?
 - d. Should the proportions of the bonuses allocated vary depending on the size of the bonus pool available? Redo the allocations of the bonus pool to these four analysts assuming that because of a high water mark constraint, the incentive fees earned in 2009 were only \$300,000.
2. Evaluate the Raven performance evaluation and incentive compensation system. What changes would you recommend, if any?

E-mail Question:

Employee compensation levels in this industry are higher than in most other industries. Is this high compensation justified, or is it evidence of one or more flaws in the corporate governance system? Explain.

Session 28

Topic: Industry Focus: Health Care

In this class, we will try to apply the knowledge we have gained in the earlier sessions to a challenging setting—control of doctors in a family medical practice.

Prepare for Class: Case—Family Care Specialists Medical Group, Inc.

Assignment Questions:

1. What purposes are served by the FCS physician compensation system? Must some of the compensation be made performance-dependent?
2. Is the current system an improvement over the QIIP that it replaced? Explain why, listing the major strengths and weaknesses of both plans.
3. Are the incentives provided by the existing system “balanced” or are some forms of initiative rewarded more generously than others? In particular, compare the average reward for seeing additional patients during regular sessions to that for seeing additional patients

during “extra” Saturday sessions. How might the existing system affect FCS physicians’ allocation of effort?

4. What are the major constraints on the design of any physician compensation system for FCS? In particular, how should FCS decide the appropriate reward, if any, for higher performance?
5. What changes to the FCS physician compensation system, if any, would you recommend to Dr. Samaniego?

E-mail Question:

Is management of doctors somehow different? In particular, should we expect doctors to respond to performance-dependent incentives like most corporate employees do, or do they have other, perhaps mostly nonpecuniary, motivations?

Session 29

Topic: Management Control in Not-for-Profit Organizations

In this session, we will discuss some control issues in a setting with which you all have some familiarity—USC.

Reading: MV, Chapter 16

Prepare for Class: Case—University of Southern California: Responsibility Center Management System

Assignment Questions:

1. Using the terminology that we used in this course, what would you call USC’s responsibility centers? Are they revenue centers? Profit centers? Something else?
2. The RCMS seems to be working reasonably well. USC has used it for over 25 years, and seemingly nobody wants to abandon it. What makes it effective?
3. Consider each of the criticisms of RCMS:
 - a. Does it sound plausible that the RCMS could have been causing, or at least contributing to, the problems if, indeed, there were problems?
 - b. Which of the problems have been solved by the RCMS refinements that were implemented over the years? Which remain?
4. What should be done now? Does the RCMS create “perverse incentives”? If so, how? If not, why not?

E-mail Question:

Very few colleges and universities use a decentralized responsibility center system like RCMS. If RCMS provides USC with a comparative advantage, why haven’t more universities implemented something like it? Conversely, if RCMS is an inferior system, why has USC used it for so long?

Session 30

Topic: Revision

In this session, we will review the major themes of the course.

Then I will hand out the final exam. It will be a take-home exam that is due in my mailbox, in the lobby of the Accounting building, by 5:00 p.m. on Thursday next week. You are expected to work on the exam individually; collusion will be considered as cheating.

Model Syllabus 4

London School of Economics

Department of Accounting

AC411

Accounting, Strategy and Control

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Overview

AC411 is focused on the study of the quintessential role of management control in decentralized organizations. Our focus will be on the measurement and evaluation of the performances of organizational entities and their managers. Management accounting at this level of analysis is an integral part of companies' *management control systems*.

In AC411, we discuss what it means to have an organization be *in control*, what alternatives managers have for ensuring good control, and how managers should choose from among various control system alternatives. Then we will focus on each of the elements of *financial control systems*, which provide the dominant form of control in the vast majority of decentralized organizations. These elements include financial target setting, performance measurement and evaluation and the assignment of various forms of organizational rewards, such as bonuses and promotions. The latter part of the course extends these key notions of management control from the *intra-organizational* level to the *inter-organizational* level, highlighting some of the difficulties involved in organizational control of new, fluid, inter-organizational settings and configurations, such as joint-ventures and various types of alliances, often involving global alliance partners. (This part is taught by an expert in this subfield who visits us for this part of the course—**Professor Henri Dekker**.)

This course is intended as an overview for individuals who will make business decisions, evaluate organizational performance or evaluate others (and/or be evaluated) through the use of financial and nonfinancial information. In other words, the module is designed to be useful particularly for those who aspire to be managers, management consultants, or specialists in staff functions such as controllers, auditors, and human resource specialists.

Pedagogy

AC411 consists of ten principal topics delivered in two sessions of 1½ hours each (see *Schedule of Topics and Sessions* below). The first session each week typically provides an introduction,

conceptual analysis, and discussion of the key facets of the topic. The second session offers a further discussion and expansion of the issues through case study analysis and real-world applications. Each session is conducted in groups of about 55 students. The case study analyses and discussions permit the exploration of management control issues in a broad range of settings (e.g., large and small firms, manufacturing and service firms, multinational firms, startups, and joint ventures). The case method of instruction, however, requires good advance preparation by the students, and every student should be ready to contribute to the case discussion when called upon. Students should expect to be “cold called” and not count on being able to hide behind classmates who volunteer to participate. I also expect active participation during the noncase sessions or “lecturettes” when I pose questions or solicit input from the students.

Readings

Merchant K & Van der Stede W, *Management Control Systems: Performance Measurement, Evaluation, and Incentives* 4e, FT: Prentice-Hall, 2017 (referred to as **MCS** in the schedule below).

Some additional materials are distributed separately in a **course pack**.

Homework

You are *required* to hand in two essays for this module drawn from the list of possible essay questions sprinkled throughout the schedule below,¹ as well as a written group project detailed under Topic 10 below. Because each essay question is related to a case study, you must turn in the essay of your choice *at the beginning* of the session in which the case is discussed. An essay that is handed in after the case has been discussed in class will not be marked; or more generally, any work turned in after it is due will be dismissed.

Assessment

AC411 is assessed by a 2-hour written exam in the week prior to the start of Lent Term (in “LT0” as it is called; that is, in early January, date and room to be determined). You will be required to answer 3 out of the 5 questions. For indicative questions, see the AC411 **exam papers from 2008, 2009, 2010, 2011, ~~2012~~, 2013, 2014, 2015, and 2016** (but *not* years prior to that, and *not* 2012, as I did not teach the course in these years). Not all the questions from these years are covered by the materials this year, so please note the pertinent questions as listed below:

- 2008: Questions 1, 2, 3, 4, 5 (not Q6)
- 2009: Questions 1, 2, 3, 4, 5 (not Q6)
- 2010: Questions 1, 2, 4, 5, 6 (not Q3)
- 2011: Questions 1, 3, 4, 5 (not Q2, not Q6)
- 2013: Questions 1, 2, 4, 5 (not Q3, not Q6)
- 2014: Questions 1, 2, 3, 4, 5 (not Q6)
- 2015: Questions 1, 2, 4, 5, 6 (not Q3)
- 2016: All questions, same format

¹ If you turn in more than the two essays required, we will retain the marks for your two best essays.

Relevant past examination questions for Professor Dekker's teaching in Sessions 7–9 are:

- Questions 4, 5, and 6 in Section A of AC410's 2006 exam paper
- Questions 7 and 8 in Section B of AC410's 2010, 2011, 2012, 2013, and 2014 papers
- Questions 5 and 6 in AC411's 2015 paper
- Questions 4 and 5 in AC411's 2016 paper

Please also note that both the duration of the exam and optionality of questions were different in all of these years *except for 2015 where the current format was first implemented*. For the avoidance of doubt, for the January 2017 exam you will be required to sit a 2-hour written exam where you will be required to answer 3 out of the 5 questions.

The final mark for AC411 is composed as follows:

Two essays (during Term)	15%
Group project (due in January)	15%
Final exam (in "LT0").....	70%

Schedule of Topics and Sessions

① Session 1.1 (Prof Van der Stede): Introduction

- MCS Chapter 1

Session 1.2 (Prof Van der Stede): Puente Hills Toyota

Case Question (for advance preparation):

Evaluate the performance measurement and incentive systems used at Puente Hills Toyota. What changes would you recommend, if any?

② Session 2.1 (Prof. Van der Stede): The Control Function of Management

- MCS Chapters 2–6

Session 2.2 (Prof. Van der Stede): Kooistra Autogroep

Case Questions (for advance preparation):

1. Did Kooistra Autogroep management go too far in decentralizing the organization? Did they not go far enough? Or did they get it just right? Why?
2. Evaluate the budgeting, performance measurement, and incentive systems used at Kooistra Autogroep. What changes would you recommend, if any?

Possible Essay Question 1 (for written work): [Think about this question in the light of both the Puente Hills Toyota and the Kooistra Autogroep cases]. Are any of the issues related to management control systems as discussed in these two cases or their preferred solutions affected in any way by the fact that the companies and its managers are Dutch or American, rather than, say, French or Chinese?

③ *Session 3.1* (Prof Van der Stede): **Decision Rights and Results Accountability**

- MCS Chapter 7
- Bouwens J & van Lent L (2007), Assessing the Performance of Business Unit Managers. *Journal of Accounting Research*, 45(4), pp. 667–697.

Session 3.2 (Prof Van der Stede): Kranworth Chair Corporation

Case Questions (for advance preparation):

1. Identify the most important key recurring decisions that must be made effectively for Kranworth Chair Corporation (KCC) to be successful. In KCC's functional organization, who had the authority to make these decisions? Who has the authority to make these decisions in KCC's new divisionalized organization?
2. Did KCC top management go too far in decentralizing the corporation? Did they not go far enough? Or did they get it just right? Why?
3. Evaluate KCC's new performance measurement and incentive system. Assuming that KCC will retain its new divisionalized organization structure, what changes would you recommend, if any? Why?

Possible Essay Question 2 (for written work): The vast majority of corporations are decentralized to a considerable degree. What kinds of organizations are best run in a largely centralized manner, and why?

④ *Session 4.1* (Prof Van der Stede): **Planning and Budgeting**

- MCS Chapter 8
- Van der Stede, W (2000), The Relationship between Two Consequences of Budget Controls: Budgetary Slack Creation and Managerial Short-term Orientation. *Accounting, Organizations & Society*, 25(6), August, pp. 609–622.

Session 4.2 (Prof Van der Stede): Las Ferreterías De México, SA de CV

Case Questions (for advance preparation):

1. Evaluate the proposed bonus plan that Mr. Gonzalez is considering.
2. How, if at all, would you modify the proposed plan?

Possible Essay Question 2 (for written work): Some managers are known for “never having missed a budget target.” Do you believe that is possible? Does such a record suggest that the managers are extremely effective managers; very lucky managers, or devious, manipulative managers? Are such managers to be congratulated (and, possibly or likely, promoted in their organizations) for their budget-achievement record?

⑤ *Session 5.1* (Prof Van der Stede): **Incentive Compensation Systems**

- MCS Chapter 9
- Van der Stede W (2007), The Pitfalls of Pay-for-Performance. *Finance & Management*, 150, Dec, pp. 10–13.

Session 5.2 (Prof Van der Stede): Houston Fearless 76, Inc.

Case Questions (for advance preparation):

1. Why are Houston Fearless 76, Inc. (HF76) managers unhappy with the company's existing sales incentive plan? Are weaknesses in this plan a major cause of the company's performance problems?
2. Evaluate the new incentive plan being contemplated. What modifications would you make to the proposed new plan, if any? How would you address the unresolved issues?
3. Are there any significant impediments to the successful implementation of the new incentive plan? If so, which?
4. Would you make any changes to the system providing bonuses to sales assistants? If so, which?

Possible Essay Question 3 (for written work): Do you believe that incentive pay is truly effort-inducing; that is, drive employees to perform at their best? Discuss?

⑥ *Session 6.1* (Prof Van der Stede): **Performance Measurement**

- MCS Chapters 10 and 11
- Kaplan, R. & Norton, D. (2005), The Balanced Scorecard: Measures that Drive Performance. *Harvard Business Review*, Jul-Aug, pp. 172–180.
- Ittner, C. & Larcker, D. (2003), Coming up Short on Nonfinancial Performance Measurement. *Harvard Business Review*, Nov, pp. 88–95.

Session 6.2 (Prof Van der Stede): Johansen's—The New Scorecard System

Case Questions (for advance preparation):

1. Why has Johansen's introduced the new scorecard system?
2. What is the company's strategy? What are the key success factors for successfully implementing that strategy? Describe the organizational structure in place at the company.
3. Consider each of the four perspectives of Johansen's new scorecard system. Why are they included? How are they measured?
4. What rating do you advocate awarding Clark? What are the key arguments you use to support that rating?

⑦ *Session 7.1* (Prof Van der Stede): **Performance Evaluations**

- MCS Chapter 12
- Gibbs, M., Merchant, K., Van der Stede, W. & Vargus, M. (2004), Determinants and Effects of Subjectivity in Incentives. *The Accounting Review*, 79(2), pp. 409–436.

Merchant and Van der Stede, *Management Control Systems: Performance Measurement, Evaluation, and Incentives*, 4e, Instructor's Manual

- Gibbs, M., Merchant, K., Van der Stede, W. & Vargus, M. (2009), Performance Measure Properties and Incentive System Design. *Industrial Relations*, 48, pp. 237–264.
- Van der Stede, W. (2009), Designing Effective Reward Systems. *Finance & Management*, 170, Oct, pp. 6–9.

Session 7.2 (Prof Van der Stede): Catalytic Solutions, Inc.

Case Questions (for advance preparation):

1. Evaluate the composition of the compensation package at Catalytic Solutions, Inc. (CSI).
 - a. What are the advantages and disadvantages of awarding stock options?
 - b. What are the advantages and disadvantages of awarding bonuses?
 - c. Was the relative importance placed on salaries, stock options, and bonus awards reasonable? Why should CSI offer a mix of rewards rather than providing its employees 100% of their compensation based on 100% salary? On 100% annual bonuses?
2. Evaluate the specific features of the annual bonus plan in 2001 and 2002. Comment on:
 - a. the choice of the number of measures used, the specific measures used, and the changes in the plan between years;
 - b. the relative proportions of financial vs. nonfinancial measures;
 - c. the decision to base rewards on company-wide, rather than individual, performance;
 - d. the amount of subjectivity allowed in determining the bonus awards;
 - e. the calibration (target difficulty) of the bonus plans.

Possible Essay Question 4 (for written work): Fast-forward 10 years. Assume that CSI has been successful. It is now a much larger, public company. It has three operating divisions (investment centers) that focus on different markets. What would you expect the CSI measurement and compensation systems to look like at that time? Why?

⑧ *Session 8.1* (Prof Dekker): **The Emergence and Management of Inter-Organizational Relationships**

- Anderson, S. & Sedatole, K. (2003), Management Accounting for the Extended Enterprise: Performance Management for Strategic Alliances and Networked Partners. In Bhimani A (Ed.), *Management Accounting in the Digital Economy* (Oxford University Press).
- Dekker, H. (2004), Control of Inter-Organizational Relationships: Evidence on Appropriation Concerns and Coordination Requirements. *Accounting, Organizations and Society*, 29(1), pp. 27–49.

Session 8.2 (Prof Dekker):

Case: *Toyota*, in: Dyer, J. & Nobeoka, K. (2000), Creating and Managing a High-Performance Knowledge-sharing Network: The Toyota Case. *Strategic Management Journal*, 21, pp. 345–367

Case Questions (for advance preparation):

1. What are the main controls used to motivate suppliers to effectively participate in knowledge sharing, and to safeguard firm knowledge from opportunistic use?
2. How effective would formal controls (e.g., monitoring mechanisms) be for these purposes? What could be the consequences of using formal controls for the effectiveness of knowledge exchange and for the relationships with suppliers?
3. How is Toyota able to reap most benefits from the collaborative practices detailed in the case? How can it maintain this situation/position?
4. Shouldn't Toyota be concerned about competitors replicating these practices? What can competitors do to improve competitiveness?

⑨ *Session 9.1* (Prof Dekker): **Contract design for Inter-Organizational Relationships**

- Anderson, S. & Dekker, H. (2015), The Role of Management Controls in Transforming Firm Boundaries and Sustaining Hybrid Organizational Forms. *Foundations and Trends in Accounting*, 8(2), pp. 75–141.
- Ding, R., Dekker, H., & Groot, T. (2013), Risk, Partner Selection and Contractual Control in Inter-Firm Relationships. *Management Accounting Research*, 24, pp. 140–155.

Session 9.2 (Prof Dekker):

Case: *IBM Microelectronics* in—Shih, W., Pisano, G., & King, A. (2008), Radical Collaboration: IBM Microelectronics Joint Development Alliances. *Harvard Business School* (case 9-608-121).

Case Questions (for advance preparation):

1. How does the shared innovation model work at IBM? Are there any particular aspects in the choice of partners that are important to the success of the model?
2. What are IBM's motivations for the Common Platform Initiative? What are IBM's motivations for the Process Development Alliances (Bulk CMOS and SOI)?
3. What control problems do you foresee in the collaborative initiatives? How might these be controlled? Also discuss under which conditions you think this model of collaborative R&D might work (i.e., which conditions are necessary for success)?

⑩ *Session 10.1* (Prof Dekker): **Management Control in Inter-Organizational Relationships**

- Anderson, S., & Dekker, H. (2015), as listed above.
- Anderson, S., Christ, M., Dekker, H., & Sedatole, K. (2014), The Use of Management Controls to Mitigate Risk in Strategic Alliances: Field and Survey Evidence. *Journal of Management Accounting Research*, 26(1), pp. 1–32.
- Anderson, S., Dekker, H., & Van den Abbeele, A. (in press), Costly Control: An Examination of the Tradeoff between Control Investments and Residual Risk in Interfirm Transactions. *Management Science*.

Assignment (Prof Dekker): This is your ***Formative Assignment #2*** due by Wednesday 18 January 2017 at the following e-mail address: h.c.dekker@lse.ac.uk.

Assignment: *The Renault-Nissan Alliance in 2008: Exploiting the Potential of a New Organizational Form* [Stanford Graduate School of Business, SM-166]

This case explains the strategic situation and challenges facing Carlos Ghosn and the Renault-Nissan Alliance in 2008 and beyond. Please discuss the following three (related) case questions:

1. The alliance could be described as a sort of “supra-corporate ecological system.” Discuss how it might exploit to a greater extent the potential of this novel organization form. Include in your discussion a consideration of which constraints, tensions and risks the alliance partners might face, and how could these be dealt with.
2. Taking into consideration the strategic change and global automotive industry dynamics that are reshaping the industry, discuss the challenges and implications of further scaling up the alliance (i.e., the further evolution of the alliance—what Ghosn calls the “fourth stage”).
3. Discuss the importance of developing further the strategic leadership capability of the alliance and the evolving role of Carlos Ghosn as CEO of both Renault and Nissan. In particular reflect on how the global strategic leadership may be developed as an organizational capability, and on the advantages and disadvantages of dual CEO-ship.

Please aim to keep the case discussion limited to a maximum of five pages (font size 11, line spacing 1.5).

Session 10.2 (Prof Van der Stede): **Revision Session**

Model Syllabus 5

Accounting 537—Management Control Systems (Evening)

Marshall School of Business, University of Southern California

Professor	Kenneth A. Merchant
Office	HOH 606
Telephone	(213) 821-5920
E-mail	kmerchant@marshall.usc.edu
Class Hours	Tuesdays, 6:30–9:30 p.m.
Classroom	JKP 202
Office Hours	By appointment. Arrange by e-mail. I will do my best to accommodate your schedule.
Honor Code	Students are expected to adhere to, and will be bound by, the University and School policies governing academic integrity.
Text	K. A. Merchant & W. A. Van der Stede (2017), <i>Management Control Systems: Performance Measurement, Evaluation, and Incentives</i> . London: Financial Times/Prentice-Hall, 4th edition.

Course Objectives

This graduate course is designed to broaden and deepen your conceptual and technical understanding of management control systems (MCS). MCS are considered broadly to include everything that managers do to ensure good performance or, more specifically, to ensure that the company's strategies get implemented effectively. But the emphasis in the course is on *financial controls*, which dominate in importance at managerial levels in all but the smallest organizations. Using financial controls requires managers to make decisions about: (1) responsibility structures (e.g., cost centers, profit centers), (2) performance measures (e.g., market, financial, and/or nonfinancial measures and their combinations), (3) performance evaluations, which take into consideration performance targets or other benchmarks, and (4) rewards (including performance-dependent compensation).

The course is issue-oriented, with current and emerging issues as a major focus. Among the issues we will discuss are control uses of measures such as EVA, EBITDA, and customer satisfaction, dashboards and Balanced Scorecards, the “stress-testing” use of financial plans, the

“Beyond Budgeting” movement, various uses of stock-based compensation, the control implications of the Sarbanes-Oxley Act of 2002, enterprise risk management, and corporate governance.

The course is built around a textbook—Merchant and Van der Stede’s *Management Control Systems*. The text is supplemented with a short monograph (de Kluyver’s *A Primer on Corporate Governance*):

(MV) K. A. Merchant & W. A. Van der Stede (2017), *Management Control Systems* (London: Financial Times/Prentice-Hall), 4th edition.

(deK) C. de Kluyver (2009), *A Primer on Corporate Governance* (New York: Business Expert Press).

Some additional materials also will be distributed on Blackboard.

The focus of most of the classes will be on discussions of cases. The readings are intended to provide background that is useful for informing the case discussions. For each case assignment, I will provide some Discussion Questions. These questions are intended to help frame and focus your reading and consideration of the course materials. In a number of the classes, I will invite a practitioner visitor to class to add expertise and to bring the topics “to life.”

Grading

Project 1	50 points
Project 2	50 points
Class participation	50 points
Final exam	<u>100 points</u>
<i>Total</i>	<i>250 points</i>

Projects

The projects will involve group analyses of cases that are supported by data provided on Excel spreadsheets. The first project is a budget “stress testing” exercise. The second involves comparative performance evaluations of a large number of bank branches. Some groups will be asked to present their analyses and conclusions in class.

Students can form their own working groups, but I will help if needed. The optimum (and maximum) group size is four. I will accept groups as small as three. As part of the grading process, I will ask students to grade each of their fellow group members. This is done to try to reduce the “free-rider” effect.

Class Participation

I assign a material proportion of the grade based on **class participation** for several reasons. First, it improves my grading accuracy. I think I can learn more from hearing you share

your ideas in a long series of classes than I can from reading what you write in a few short exam sessions.

But perhaps more important than that, grading class participation motivates class participation, and having highly interactive class sessions helps the learning process. Active class participation encourages students to be well prepared and thus to become active, rather than passive, learners. Participation provides students with the opportunity to gain from the experiences and talents of everyone in the class. And class participation helps students improve their oral communication skills. This is important because research shows that people in business tend to spend very little time reading and even less time writing reports. A great deal of managers' and other professionals' interactions with others are through oral communication.

Class participation evaluation will be based primarily on the quality of the participation in classroom discussions. To be clear on what I am looking for regarding class participation, and to further aid in your preparation, I have listed below some characteristics of effective class participation:

- (1) Does the class member make points that are especially pertinent to the discussion? Do they increase the understanding of the class or are they simply a regurgitation of the problem or case facts?
- (2) Is there continuity in one's contribution from what has been said previously during class, or are the comments disjointed, isolated, or tangential? The best class contributions are those that reflect not only excellent preparation, but also good listening, interpretive and integrative skills.
- (3) Do the comments reflect a willingness to put forth new, challenging ideas or are they always agreeable and "safe"?
- (4) Is the participant able and willing to interact with others by asking questions, providing supportive comments or challenging **constructively** what has been said?

Participation will be evaluated based on a near-continuous scale, the end points of which can be described as follows:

Outstanding Contributor: This person's contributions reflect exceptional preparation, and the ideas offered are always substantive and provide major insights and direction for the class. If this person were not a member of the class, the quality of the discussions would be diminished significantly.

Unsatisfactory Contributor: This person may be absent from class or someone who rarely participates in class discussion. Alternatively, this person's contribution in class reflects inadequate preparation and/or understanding. Ideas offered are not substantive and provide few, if any, insights and never a constructive direction for the class. Integrative comments and effective arguments are absent. Class comments are either obvious, isolated from the main discussion, or confusing to the class.

Final Exam

The final exam will test **individual** (not group) work. The **final exam** will be a take-home exam in lieu of an exam during the final exam period. It will involve a case analysis. No make-up exams will be given (see LSOA policy on incompletes).

E-Mail Questions

On the bottom of many of the class assignments, you will see that I have included an “e-mail question.” Prior to noon before each of our classes, please send me an e-mail message or private Blackboard posting answering the question(s) for that day’s class. This is not intended to be a time-consuming obligation. Your answers should be brief—**three sentences or less** for each question.

Your answers to the e-mail questions serve multiple purposes. First, they help me to get to know you and how you think. Second, these messages open the communication channels between us. Since you have to send me a message, it is easy to append another thought. In the past some students have used this opportunity to ask a question on another topic or to give me some feedback about the course. I welcome this. Third, your e-mail answers help me orient the class discussion. For example, they help me both to judge the mindset of the class and to find people with unique perspectives. Finally, the questions are functional because they encourage good advance preparation. The regularity with which you input your e-mail question answers on a timely basis and the quality of your answers will form part of your participation grade.

Schedule of Classes

Week 1

Topic: The Control Function of Management

In this first session, we will go over the syllabus and get to know each other. Then I will provide a general lecture on managers’ control options. Finally, we will discuss some control vignettes and a case.

Reading: MV, Chapters 1–4

Prepare for Class: Case—Atlanta Home Loan

Assignment Questions:

1. Identify the devices (controls) that Al Fiorini used to control his business both before and after he went back to school. Classify each control as a results, action, or personnel or cultural type of control.
2. What went wrong? Did Al use the wrong types of controls? Did he use the right types of controls but fail to design or implement them properly? Or was he just unlucky?
3. What should Al Fiorini do now? Why?

Week 2

Topic: Results Controls

In the first part of the class, we will discuss a control system evaluation case which illustrates the control system used in a field service engineer (FSE) setting. The case is particularly interesting because the company, Diagnostic Products Corporation (DPC), is in the midst of a significant change. Formerly, company managers controlled FSE inputs—they paid FSEs for hours worked. Now they are attempting to measure FSE outputs, or results, and to provide performance-dependent compensation.

In the second part of the class, we will examine and critique the performance measurement and incentive systems in two companies in an industry with which all of you have some familiarity—automobile retailing. The two companies' systems are quite different. Can we say which one is the better design? What might explain the differences?

Reading: MV, Chapters 5, 6, and 9

Prepare for Class: Cases—Diagnostic Products Corporation (DPC)

Puente Hills Toyota

Kooistra Autogroep

Assignment Questions:

Diagnostic Products Corporation (DPC)

1. Evaluate the design of the DPC Performance Bonus Program for U.S.-based field service engineers (FSEs) as it currently exists and the way in which the Program is being implemented.
2. What changes would you suggest, if any?

Assignment Questions:

Puente Hills Toyota and Kooistra Autogroep

1. Compare and contrast the performance measurement and incentive systems used at Puente Hills Toyota and Kooistra Autogroep.
2. When comparing the use of incentives in the two companies, do you believe that incentive pay is truly effort-inducing; that is, does it drive employees to perform at their best? If you believe incentive pay is not, in whole or in part, effective in making employees work harder, then what other potentially useful purposes does variable incentive pay provide for organizations relying on it, if any?
3. What advice would you provide to the managers of these companies?

E-mail Question:

As a first approximation, which of the following statements do you believe is most correct, and why:

- I. People are people. They respond approximately equally to many things, including incentive systems.
- II. To work well, a company's incentive systems must be tailored in many ways to fit the specific desires of various employee groups.

Week 3

Note: The names of the individuals working on the two group projects are due to me by the start of this class. The optimum (and maximum) group size is four. Groups of three are permissible. Please have a representative send me an e-mail message with the names of the individuals in your group.

Topic: Financial Responsibility Structures and Problems Caused by Interdependence

The focus of the first part of this session is on one of the main management control system choices—design of the organization's authority and financial responsibility structures. Some of these choices create organizational interdependence—products or services are provided by one organizational entity to another. Interdependence, in turn, often creates cost allocation or transfer pricing problems. In the second part of this session, we will discuss a representative example.

Reading: MV, Chapter 7

Prepare for Class: Cases—Kranworth Chair Corporation
Zumwald AG

Assignment Questions:

Kranworth Chair Corporation

1. Identify the most important key recurring decisions that must be made effectively for KCC to be successful. In KCC's functional organization, who had the authority to make these decisions? Who has the authority to make these decisions in KCC's new divisionalized organization?
2. Did KCC top management go too far in decentralizing the corporation? Did they not go far enough? Or did they get it just right? Why?
3. Evaluate KCC's new performance measurement and incentive system. Assuming that KCC will retain its new divisionalized organization structure, what changes would you recommend, if any? Why?

4. Assume that the R&D function is to be decentralized (given to the divisions). Would this necessitate changes to KCC's performance measurement and incentive system? If so, which and why? If not, why not?

Assignment Questions:

Zumwald AG

1. What sourcing decision for the X73 materials is in the best interest of:
 - a. The Imaging Systems Division?
 - b. The Heidelberg Division?
 - c. The Electronic Components Division?
 - d. Zumwald AG?
2. What should Mr. Fettinger do?

E-mail Question:

Is a transfer price just a cost allocation with a profit margin tacked onto it? Explain.

Week 4

Topic: Budgeting or "Beyond Budgeting"

Planning and budgeting processes are important, and often complex, elements of companies' management control systems. Most firms beyond minimal size, but not all, engage in often extensive planning processes, the annual component of which is called budgeting. The Mainfreight case that we will discuss in the first part of this class, however, illustrates the functioning of a large, successful international logistics company that does *not* engage in an annual budgeting process. The goal in this case is to think about what budgeting is, and what it is not, and how Mainfreight can succeed without having a budget, which is a control system element that most companies think is essential. One of the key points of discussion of this session, therefore, is to consider whether there are valid, effective alternatives to budget-based performance management systems, and if so, whether these really are what they claim to be or just budgeting processes under a different guise?

In the second part, we will examine the "planning and budgeting system" of another company that has gone "Beyond Budgeting." The approach illustrated in Statoil is probably superior to what most companies do and, thus, perhaps an innovation that will spread? Or might it be a fad that will soon die out?

Reading: MV, Chapter 8

Prepare for Class: Cases—Mainfreight

Statoil

Assignment Questions:

Mainfreight

1. At the very least, Mainfreight's management systems are nontraditional.
 - a. What are the key elements of Mainfreight's results control systems?
 - b. Why did Mainfreight managers decide to take a nontraditional approach?
 - c. How does Mainfreight perform the functions typically fulfilled by budgets? Or are some of those functions really not that important?
 - d. Does the Mainfreight system address the limitations of traditional budgets? Does it introduce new limitations?
2. Is Mainfreight a well-controlled organization?
3. Should companies that now use an annual budgeting process try to emulate some or all of the management systems used by Mainfreight? Why or why not?

Assignment Questions:

Statoil

1. Statoil managers claim that their company no longer prepares a budget. What do they mean by that claim?
2. Why did Statoil decide to abandon budgeting?
3. Describe the new processes that Statoil implemented to replace the budget. What are its strengths and weaknesses?
4. Is the Statoil "Ambition-to-Action" system just a routine implementation of the Beyond Budgeting approach, or does it include some additional features or fail to uphold some of the Beyond Budgeting principles?
5. The "Beyond Budgeting" approach is still relatively rare outside Europe. Why? Is there something about non-European cultures that limits its applicability, or are other companies just slow to catch on to an innovation that has started in Europe?

E-mail Question:

Mainfreight's top executives, three of whom are qualified accountants, maintain that their company does not prepare budgets. Is that contention accurate? How should one determine whether a company prepares a budget or not?

Week 5

Topic: The Planning Role of Budgets: Business Stress Testing (Group Project 1)

Planning is decision making in advance. Using the financial statement format in a future-looking sense (i.e., budgeting) allows managers to anticipate what might be coming their way in various plausible scenarios.

In this class session, we will consider the work you have done for your first group project. Some of the groups will present their findings. The group presentations will either reinforce each other or, if they are different, we will compare and contrast them.

Case: VisuSon, Inc.

The assignment is posted on Blackboard.

Week 6

Topic: Summary Financial Performance Measures: Advantages and Limitations

There are many forms of summary financial performance measures. Are some better than others?

Reading: MV, Chapter 10

Prepare for Class: Cases—Behavioral Implications of Airline Depreciation Accounting Policy Choices

Berkshire Industries, Inc.

Assignment Questions:

Behavioral Implications of Airline Depreciation Accounting Policy Choices

Assume that at least some rewards for the management team (and, hence, also other employees) are based on performance measured in terms of accounting income and returns on net assets. Also assume that all of these airlines are growing; that is, they are adding to their fleet of aircraft.

1. What are the behavioral implications of each of the three depreciation-related accounting policy choices:
 - a. depreciation patterns (i.e., straight-line vs. accelerated);
 - b. estimated useful lives; and
 - c. residual values?

Consider, at a minimum, the effects of each of these choices on decisions regarding:

- a. replacements of aircraft in service;
 - b. pricing, assuming that prices are at least somewhat dependent on costs;
 - c. evaluations of routes or lines of business;
 - d. evaluations of managers, assuming that negotiated budgets provide the primary standards of performance.
2. Assume that in a particular U.S. airline company there is a conflict between the benefits of conservatism vs. liberalism in depreciation accounting. That is, for this company conservatism in depreciation accounting is greatly preferred for financial reporting purposes (for whatever reason) but for internal purposes the company would be better off if the policies were more liberal, or vice versa. Would you recommend to the managers of this

company that they adopt a third set of books? That is, should they maintain one set of books for financial accounting purposes, another set for tax purposes, and a third set for the purposes of running the business?

3. If the managers of a particular airline do not want to maintain a third set of books, should they tend to be conservative or liberal in their aircraft depreciation accounting?

Assignment Questions:

Berkshire Industries, Inc.

1. Were Berkshire's motivations for a new incentive system reasonable? If so, what were their main options for a new system? Was an economic profit-focused system a reasonable choice?
2. Evaluate the Berkshire Industries' new incentive plan. What changes would you recommend, if any?
3. What, if anything, should Mr. Embleton do about the problems caused by performance shortfalls in the Spirits Division? Explain.

E-mail Question:

International Financial Reporting Standards (IFRS) are less prescriptive than current U.S. GAAP, and the interpretive guidance that is provided is more limited. More judgment is needed by managers in firms following IFRS, so this question will become more relevant after U.S. firms shift over to IFRS: Should judgments about financial reporting policies be affected significantly by concerns about the possible effects on behaviors of employees of the firm, or should they be chosen solely based on judgments about what is perceived to provide the best financial reporting disclosures?

Week 7

Topic: Combinations of Measures: KPIs, Dashboards, and Balanced Scorecards

The focus of this session is on the concurrent use of multiple performance measures. The most popular combination-of-measures system is marketed as "Balanced Scorecard." But some variations are given alternative names, such as dashboards, KPIs and performance prisms.

Reading: MV, Chapter 11

Prepare for Class: Case—Catalytic Solutions, Inc.

Johansen's—The New Scorecard System

Assignment Question:

Catalytic Solutions, Inc.

Evaluate the CSI performance measurement and compensation systems. What changes would you suggest be made, if any? Explain.

Assignment Questions:

Johansen's—The New Scorecard System

1. Why has Johansen's introduced the new scorecard system?
2. What is the company's strategy? What are the key success factors for successfully implementing that strategy? Describe the organizational structure in place at the company.
3. Consider each of the four perspectives of Johansen's new scorecard system. Why are they included? How are they measured?
4. What rating do you advocate awarding Clark? What are the key arguments you use to support that rating?

E-mail Question:

- What kinds of companies should implement a basket-of-measures approach, such as balanced scorecard, rather than just monitoring and rewarding their general managers' performances based on a single bottom-line summary performance measure?

Week 8

Topic: Performance Evaluations: Adjusting for the Effects of "Uncontrollables"

In the first part of this class, we will continue our discussion of performance evaluations. How can/should firms deal with the effects of uncontrollable events that often obscure managers' impacts on performance measures?

I will dismiss class early to allow you to start working on the second group project, which is due for presentation in class next week.

Reading: MV, Chapter 12

Prepare for Class: Case—Olympic Car Wash

Beifang Chuang Ye Vehicle Group

Assignment Question:

Olympic Car Wash

How large should the bonus pool be for the Aalst location?

Assignment Question:

Beifang Chuang Ye Vehicle Group

To what extent, if at all, should Mr. Zhou provide incentive compensation for his employees when his company is losing money? Why? What factors did you take into consideration in making your judgment?

E-mail Question:

Some companies make performance evaluation and bonus adjustments to protect managers from the harmful effects of many uncontrollable factors. Other companies make no such adjustments. Is one of these approaches clearly inferior, or is this just a “management style” choice?

Week 9

Topic: Performance Evaluations (Group Project 2)

Case: Fine Harvest Restaurant Group

In the first part of this class session, your groups will present the findings of the performance evaluation group project exercise. The assignment and the *Fine Harvest Restaurant Group* database that go with it are posted on Blackboard. In the last part of the class (I hope), an expert class visitor will provide both some reactions to your presentations and some color about this real world consulting assignment.

Week 10

Topic: The Role of Controllers and Control Impacts of the Sarbanes-Oxley Act

In the first part of this session we will discuss a case that allows us to consider the role of controller/CFO in a more stressful time. In the second part, we will focus on the benefits and costs to corporations of the Sarbanes-Oxley Act of 2002 (SOX).

Reading: MV, Chapters 13–15

Prepare for Class: Case—Don Russell: Experiences of a Controller/CFO

Pacific Sunwear of California, Inc.

Assignment Questions:

Don Russell: Experiences of a Controller/CFO

1. Does Don have the power to force ETI top management to make a correcting accounting entry? If not, what should he do? If so, should he force the entry to be made, and how large should it be?
2. Are earnings management practices such as took place at C&S and ETI smart? Are they ethical?
3. Does Don Russell have an obligation greater than that of other employees to try to ensure that his corporation acts ethically?

Assignment Questions:

Pacific Sunwear of California, Inc.

1. Evaluate the process that PacSun went through to comply with SOX, and particularly SOX Section 404. Was that process as effective and efficient as it could have been?

2. Are the “significant deficiencies” that were identified in each of the two years of the audit evidence of control system flaws or largely irrelevant technical violations? Another way to phrase this question might be: Should disclosure of these deficiencies have had a negative effect on PacSun’s stock price?
3. PacSun executives seem convinced that the costs of complying with SOX were greater than the benefits to the company. Why did PacSun not benefit from the compliance process to the same extent as some other companies? Or were their compliance costs too high?

E-mail Question:

If the Sarbanes-Oxley law had been passed prior to the time of the events described in the Don Russell case, would it have prevented the problems faced at ETI?

Week 11

Topic: Enterprise Risk Management

Our focus in the first part of this session is broadly on systems of corporate governance and the roles and obligations of boards of directors. Then we will focus on enterprise risk management, a newly developing tool aimed at helping board members and managers address all the various kinds of risks that the company might face.

Reading: deK, Chapters 1, 2, 3, and 6, particularly pp. 107–108, and Appendix C.

Prepare for Class: Case—Entropic Communications, Inc.

Andrew G. Scavell, Chief Risk Officer

Assignment Questions:

Entropic Communications, Inc.

1. Why did Entropic implement a formal enterprise risk management (ERM) process?
2. Do you think the company realized the benefits of ERM as envisioned by COSO? Why or why not?
3. What changes would you suggest for making the ERM process at Entropic more effective?

Assignment Questions:

Andrew G. Scavell, Chief Risk Officer

1. What was the key rationale or impetus for the risk management drive at LP&F?
2. Was Andy the right person to drive this risk management effort? Was ERM eventually being formalized through the right role in LP&F? Which are the critical tensions in this role? Was Andy best placed—either through prior experience and/or through the way the new role was conceived—to deal with these tensions effectively?

3. Describe in a concise, well-structured format the key tenets of the risk management process that Andy had devised. Was this process effective? Accepted by all? Complete? Overall, what are the strengths and weaknesses of the ERM process?
4. Do you reckon the company realized the benefits of ERM as envisioned by Andy and/or the board? Why or why not?
5. What changes, if any, would you suggest for making the ERM process at LP&F more effective?

E-mail Question:

ERM is currently one of the hot topics in management. Virtually every company is looking at the technique and deciding whether and how to use it. Do you think the ERM technique is a fad that will soon disappear or an improvement that will provide enduring benefits to a broad range of companies?

Week 12

Topic: Fiduciary Obligations of Board of Directors

In this class, we will discuss two cases with corporate governance issues.

Reading: deK, Chapters 8 and 9

Prepare for Class: Cases—Arrow Motorcar Corporation
Golden Parachutes?

Assignment Questions:

Arrow Motorcar Corporation

1. Why did Arrow Motorcar Corporation have a board of directors before it went public? How (if at all) do the legal and moral obligations of private-company directors differ from those of directors of publicly-held companies?
2. Evaluate the board composition and actions. All things considered, did the board act properly? Did the board members choose the optimal time to terminate Billy Ray Repko?
3. What should the board members do now (March 22, 2016)?
4. What could have prevented or minimized the problems that Arrow faced?

Assignment Questions:

Golden Parachutes?

1. If the proposed severance agreement is implemented, who benefits and who loses?

2. Should the compensation committee approve the severance agreement as is? Should some of the elements of the agreement be modified? Or should DTI not have a severance agreement?
3. Suppose that you, as Dennis Feingold, object strongly to at least some of the elements of the severance agreement but that the other two members of the DTI compensation recommend adopting the agreement as it is written. Would it be worthwhile for you to voice your objections forcefully and, perhaps, to take the issue to the full board of directors? Or would you consider it adequate just to cast a negative vote when the issue comes up in the compensation committee?

E-mail Question:

Identify the ethical issues you see in these cases? What makes them ethical issues?

Week 13

Topic: Industry Applications—A Family Business and a Family Medical Practice

In this session, we will practice applying knowledge we have gained in earlier sessions. First we will examine a proposal to change a sales incentive program. Then we will consider how to motivate doctors in a family medical practice.

Prepare for Class: Case—Houston Fearless 76, Inc.

Family Care Specialists Medical Group, Inc.

Assignment Questions:

Houston Fearless 76, Inc.

1. Why are Houston Fearless 76, Inc. (HF76) managers unhappy with the company's existing sales incentive plan? Are weaknesses in this plan a major cause of the company's performance problems?
2. Evaluate the new incentive plan being contemplated. What modifications would you make to the proposed new plan, if any? How would you address the unresolved issues?
3. Are there any significant impediments to the successful implementation of the new incentive plan? If so, which?
4. Would you make any changes to the system providing bonuses to sales assistants? If so, what?

Assignment Questions:

Family Care Specialists Medical Group, Inc.

1. What purposes are served by the FCS physician compensation system? Must some of the compensation be made performance-dependent?

2. Is the current system an improvement over the QIIP that it replaced? Explain why, listing the major strengths and weaknesses of both plans.
3. Are the incentives provided by the existing system “balanced” or are some forms of initiative rewarded more generously than others? In particular, compare the average reward for seeing additional patients during regular sessions to that for seeing additional patients during “extra” Saturday sessions. How might the existing system affect FCS physicians’ allocation of effort?
4. What are the major constraints on the design of any physician compensation system for FCS? In particular, how should FCS decide the appropriate reward, if any, for higher performance?
5. What changes to the FCS physician compensation system, if any, would you recommend to Dr. Samaniego?

E-mail Question:

Should we expect doctors to respond to performance-based incentives like salespeople do, or do they have mostly non-pecuniary motivations?

Week 14

Topic: Industry Applications: A “Billings Scorecard” and Control of a Not-for-Profit Organization

In the first part of this class we will discuss an innovative results-control approach to solution of a problem that is usually addressed with development and enforcement of sets of policies and procedures. In the second part, we will discuss some control issues in a setting with which you all have some familiarity—USC.

Reading: MV, Chapter 16

Prepare for Class: Cases—Game Shop, Inc.

University of Southern California: Responsibility Center Management System

Assignment Questions:

Game Shop, Inc.

1. Why was GSI’s production quality control performance so much better than its billing performance?
2. Evaluate the billing improvement effort and each of the elements of the system that emerged. Comment specifically on the billing scorecard, detention meetings, P-CARs, and any other system elements that you believe are relevant.
 - a. In considering the scorecard, be sure to address the following questions: What are the Scorecard and each of its measures trying to accomplish? Are these the right measures? Does each measure add unique value? Are the measures weighted appropriately in

- importance? Are the business unit grades generally consistent across measures? Can any of the measures be distorted or gamed?
- b. Do you believe that David's improvement efforts will close the gap between production and billing performance enough to meet project goals? Explain?
 - c. Do you have any suggestions to improve the billing process? Explain.
3. GSI's ultimate goal is "perfection." Can this system be used to achieve billing perfection as it is designed, or will changes have to be made, or might even a totally different approach be necessary? Explain.
 4. The Billing Scorecard is a results-accountability approach to address the problem, chosen because this company's culture is "metrics centric." What are the advantages and disadvantages of using a results-accountability approach? What other alternatives might have been used to solve the problem?

Assignment Questions:

University of Southern California: Responsibility Center Management System

1. Using the terminology that we used in this course, what would you call USC's responsibility centers? Are they revenue centers? Profit centers? Something else?
2. The RCMS seems to be working reasonably well. USC has used it for over 25 years, and seemingly nobody wants to abandon it. What makes it effective?
3. Consider each of the criticisms of RCMS:
 - a. Does it sound plausible that the RCMS could have been causing, or at least contributing to, the problems if, indeed, there were problems?
 - b. Which of the problems have been solved by the RCMS refinements that were implemented over the years? Which remain?
4. What should be done now? Does the RCMS create "perverse incentives"? If so, how? If not, why not?

E-mail Question:

Would you include billing performance among a short list of "critical success factors" for GSI? If so, why has it apparently not received much attention from management up until now? If not, why all the concern now?

Week 15

Topic: Industry Applications: A Hedge Fund

In the first part of this session we will discuss issues related to performance evaluation and incentive compensation in a hedge fund, with our primary focus on the role of the hedge fund analysts.

At the end of the session I will review the major themes of the course, and I will hand out the final exam. It will be a take-home exam that is due in my mailbox, in the lobby of the Accounting building, by 5:00 p.m. on Thursday next week. You are expected to work on the exam individually; collusion will be considered as cheating.

Prepare for Class: Case—Raven Capital, LLC

Assignment Questions:

1. Assume the role of a Raven portfolio manager who has to allocate a bonus pool to the four analysts working primarily for him. Assume a 20% incentive fee for Raven. Use 30% of the incentive fee as the bonus pool to be allocated to the four analysts whose backgrounds and 2009 portfolio performances are described in Assignment Figures A and B (posted separately on Blackboard).
 - a. How would you allocate bonuses to these four analysts? What alternatives did you consider? Why did you make the choices you did?
 - b. Is there any other information you would like to have had available before making your decisions? If so, which?
 - c. Do you think you should pay out the entire bonus pool this year, or hold some money in a “bonus bank reserve”? Why or why not?
 - d. Should the proportions of the bonuses allocated vary depending on the size of the bonus pool available? Redo the allocations of the bonus pool to these four analysts assuming that because of a high water mark constraint, the incentive fees earned in 2009 were only \$300,000.
2. Evaluate the Raven performance evaluation and incentive compensation system. What changes would you recommend, if any?

E-mail Question:

Employee compensation levels in this industry are higher than in most other industries. Is this high compensation justified, or is it evidence of one or more flaws in the corporate governance system? Explain.

Case Matrix

	Source	1 - Management and Control	2 - Results Controls	3 - Action, Personnel, and Cultural Controls	4 - Control System Tightness	5 - Control System Costs	6 - Designing and Evaluating Management Control Systems	7 - Financial Responsibility Centers	8 - Planning and Budgeting	9 - Incentive Systems	10 - Financial Performance Measures and Their Effects	11 - Remedies to the Myopia Problem	12 - Using Financial Results Controls in the Presence of Uncontrollable Factors	13 - Corporate Governance and Boards of Directors	14 - Controllers and Auditors	15 - Management Control-Related Ethical Issues	16 - Management Control in Not-for-profit Organizations	Integrative case	Database case designed for group project
1. Leo's Four-Plex Theater	Authors	✓		✓	✓	✓													
2. Wong's Pharmacy	Authors	✓																	
3. Private Fitness, Inc.	Authors	✓		✓	✓	✓	✓												
4. Atlanta Home Loan	Authors	✓		✓			✓												
5. Office Solutions, Inc.	Authors		✓							✓			✓						
6. Puente Hills Toyota	Authors		✓			✓	✓			✓	✓		✓					✓	
7. Kooistra Autogroep	Authors		✓					✓		✓								✓	
8. Houston Fearless 76, Inc.	Authors		✓						✓	✓									
9. Whisky and Associates, Inc.	Authors			✓	✓										✓				
10. The Platinum Pointe Land Deal	Authors			✓		✓									✓				
11. EyeOn Pharmaceuticals, Inc.	Authors			✓															
12. Axion N.V.	Authors			✓		✓		✓										✓	
13. Controls at the Bellagio Casino Resort	Authors			✓	✓														
14. PCL: A Breakdown in the Enforcement of Management Control	U of HK	✓	✓	✓	✓		✓												
15. Philip Anderson	Authors					✓										✓			
16. Sunshine Fashion: Fraud, Theft, and Misbehavior among Employees	U of HK	✓		✓		✓	✓												

Merchant and Van der Stede, *Management Control Systems: Performance Measurement, Evaluation, and Incentives*, 4e, Instructor's Manual

	Source	1 - Management and Control	2 - Results Controls	3 - Action, Personnel, and Cultural Controls	4 - Control System Tightness	5 - Control System Costs	6 - Designing and Evaluating Management Control Systems	7 - Financial Responsibility Centers	8 - Planning and Budgeting	9 - Incentive Systems	10 - Financial Performance Measures and Their Effects	11 - Remedies to the Myopia Problem	12 - Using Financial Results Controls in the Presence of Uncontrollable Factors	13 - Corporate Governance and Boards of Directors	14 - Controllers and Auditors	15 - Management Control-Related Ethical Issues	16 - Management Control in Not-for-profit Organizations	Integrative case	Database case designed for group project
17. Better Beauty, Inc.	Authors		✓			✓				✓								✓	
18. Fit Food, Inc.	Authors	✓				✓			✓									✓	
19. Atlantis Chemical Industries	Authors					✓						✓				✓			
20. Diagnostic Products Corporation	Authors	✓					✓			✓		✓							
21. Game Shop, Inc.	Authors	✓					✓			✓			✓						
22. Family Care Specialists Medical Group, Inc.	Authors	✓					✓			✓									
23. Kranworth Chair Corporation	Authors	✓						✓		✓			✓						
24. Zumwald AG	Authors							✓											
25. Global Investors, Inc.	Authors							✓											
26. Royal Wessanen NV	Authors	✓							✓	✓			✓						
27. The Stimson Company	Authors		✓						✓				✓						
28. Multiple Versions of the Plan	Authors								✓							✓			
29. Vitesse Semiconductor Corporation	Authors								✓		✓							✓	
30. VisuSon, Inc.: Business Stress Testing	Authors								✓									✓	
31. Harwood Medical Instruments PLC	Authors	✓								✓									
32. Superconductor Technologies, Inc.	Authors	✓							✓	✓	✓	✓							
33. Raven Capital, LLC	Authors	✓								✓			✓						
34. Behavioral Implications of Airline Depreciation Accounting Policy Choices	Authors										✓								
35. Las Ferreterías de México, S.A. de C.V.	Authors					✓					✓								
36. Industrial Electronics, Inc.	Authors	✓				✓				✓									

Merchant and Van der Stede, *Management Control Systems: Performance Measurement, Evaluation, and Incentives*, 4e, Instructor's Manual

	Source	1 - Management and Control	2 - Results Controls	3 - Action, Personnel, and Cultural Controls	4 - Control System Tightness	5 - Control System Costs	6 - Designing and Evaluating Management Control Systems	7 - Financial Responsibility Centers	8 - Planning and Budgeting	9 - Incentive Systems	10 - Financial Performance Measures and Their Effects	11 - Remedies to the Myopia Problem	12 - Using Financial Results Controls in the Presence of Uncontrollable Factors	13 - Corporate Governance and Boards of Directors	14 - Controllers and Auditors	15 - Management Control-Related Ethical Issues	16 - Management Control in Not-for-profit Organizations	Integrative case	Database case designed for group project
37. Haengbok Bancorp	Authors		✓								✓								
38. Corbridge Industries, Inc.	Authors										✓								
39. King Engineering Group, Inc.	Authors	✓							✓		✓								
40. Berkshire Industries PLC	Authors	✓							✓		✓		✓						
41. Catalytic Solutions, Inc.	Authors		✓				✓			✓		✓							
42. Dormunder-Koppel GmbH	Authors		✓							✓		✓							
43. Johansen's: The New Scorecard System	Darden		✓							✓		✓							
44. Mainfreight	O'Grady											✓							
45. Statoil	Authors								✓		✓	✓					✓		
46. Olympic Car Wash	Authors												✓						
47. Beifang Chuang Ye Vehicle Group	Authors												✓						
48. Hoffman Discount Drugs, Inc.	Authors	✓								✓			✓						
49. Howard Building Corporation, Inc.	Authors			✓					✓				✓						
50. Bank of the Desert (A) and (B)	Authors									✓		✓	✓					✓	
51. Fine Harvest Restaurant Group (A) and (B)	Authors											✓	✓					✓	
52. Arrow Motorcar Corporation	Authors													✓					
53. Golden Parachutes?	Authors													✓					
54. Pacific Sunwear of California, Inc.	Authors		✓											✓					
55. Entropic Communications, Inc.	Authors													✓					
56. Bio/Precise Medical Devices, Inc.	Authors					✓								✓					
57. Don Russell: Experiences of a Controller/CFO	Authors					✓								✓		✓			

Merchant and Van der Stede, *Management Control Systems: Performance Measurement, Evaluation, and Incentives*, 4e, Instructor's Manual

	Source	1 - Management and Control	2 - Results Controls	3 - Action, Personnel, and Cultural Controls	4 - Control System Tightness	5 - Control System Costs	6 - Designing and Evaluating Management Control Systems	7 - Financial Responsibility Centers	8 - Planning and Budgeting	9 - Incentive Systems	10 - Financial Performance Measures and Their Effects	11 - Remedies to the Myopia Problem	12 - Using Financial Results Controls in the Presence of Uncontrollable Factors	13 - Corporate Governance and Boards of Directors	14 - Controllers and Auditors	15 - Management Control-Related Ethical Issues	16 - Management Control in Not-for-profit Organizations	Integrative case	Database case designed for group project
58. Desktop Solutions, Inc. (A): Audit of the St. Louis Branch and (B): Audit of Operations Group Systems	Authors																		
59. Andrew G. Scavell, Chief Risk Officer	Authors						✓		✓					✓	✓				
60. Two Budget Targets	Authors					✓			✓							✓			
61. Conservative Accounting in the General Products Division	Authors					✓					✓					✓			
62. Education Food Services at Central Maine State University	Authors					✓			✓							✓			
63. The "Sales Acceleration Program"	Authors					✓					✓					✓			
64. The Expiring Software License	Authors					✓					✓					✓			
65. Wired, PLC	Authors										✓					✓			
66. Mean Screens USA, Inc.	Authors										✓					✓			
67. Lernout & Hauspie Speech Products	Authors										✓				✓	✓			
68. Ethics@Cisco	Authors			✓												✓			
69. SCL Ontario: Achieving, Measuring, and Communicating Strategic Success	Ivey																✓		
70. University of Southern California: Responsibility Center Management System	Authors					✓											✓	✓	

The Case Method of Instruction: Suggestions for Students

All teaching methods are aimed at producing learning. Learning occurs when someone's skills, knowledge, or beliefs change, more than temporarily, because of an encountered situation.

Most students are intimately familiar with the lecture method of instruction because it is the primary, if not the sole, formal teaching method to which they have been exposed. Lecturing imparts knowledge through a deductive reasoning process, which begins with a formal statement of a conceptual structure or theory and then illustrates the structure with examples and problems. Lectures, supported with readings, visual aids, exercises, and problems sets, are the most efficient way to begin to transmit knowledge about specific facts, rules, and structured techniques.

In management-related education, however, the value of lecturing has some sharp limitations because facts, rules, and techniques are a relatively minor part of what budding managers and functional specialists must learn. Most business professionals operate in complex, changing environments, and they often must make judgments and take actions without having complete sets of reliable information. They cannot perform their jobs well merely by referring to neat lists of rules and theories and compilations of facts. They need to develop job skills, philosophies, and approaches. It's not as much what managers know that determines their success or failure; it is how they think and act. To enhance thinking skills, most people believe that more active teaching styles, in particular the case method of instruction, are superior to instructor-focused, lecture-type methods.

The Case Method

The case method of teaching stimulates learning through the analysis of actual events. The primary distinguishing feature of the case method is that students play an active, rather than a passive, role in the learning process and, particularly, the classroom. The method develops a

Professor Kenneth A. Merchant prepared this note to facilitate students' adaptation to case courses. Professors Sam Hariharan and S. Mark Young provided useful suggestions.

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subject inductively by actively involving students in discussions of large numbers of cases in planned combinations.

Cases, which provide descriptions of actual (or sometimes hypothetical) administrative situations, are obviously one key ingredient for case learning. Business cases come in multiple forms. Most of the cases that are taught inductively¹ are either diagnostic or decision cases (or combinations of the two forms). **Diagnostic** (or evaluative) cases provide descriptions of successes or failures managers have had so that students can develop their skills of identifying causal links between systemic features and outcomes. Some of these cases describing managerial successes can be called “anatomy” cases; those describing failures can be viewed as “pathology” cases. Often a course is organized through the use of a series of diagnostic cases that help students understand when a particular management choice or style is effective. The other common case form—**decision** cases—allows students to step figuratively into the decision makers’ shoes. The basic question these cases pose is: What should be done? Like in the real world, however, the decision-relevant information provided in these cases is incomplete and partially unreliable, so a solution cannot be reached solely through structured analysis techniques. Many cases **combine** the diagnostic and decision purposes. They require students both to analyze the situation and prepare an action plan.

Another key ingredient for case learning is a “Socratic” teaching style that gives students the primary responsibility for analyzing the case and providing recommendations. A case instructor’s role is to facilitate the discussion, not to put the “right answer” on the board (even when a right answer exists).

Advantages and Disadvantages of the Case Method

Management educators are increasingly recognizing that more active methods of learning must necessarily be a part of a broad gauge approach to management education and development. For example, in 1990, in their first position statement, the Accounting Education Change Commission, a group endeavoring to improve accounting education, stated:

Students must be active participants in the learning process, not passive recipients of information. They should identify and solve unstructured problems that require use of multiple information sources.

Most accounting instructors have interpreted this statement as a call for greater use of the case method of instruction.²

Proponents believe that the case method has some powerful advantages over less active methods of learning, including:

1. **Development of effective thinking processes.** The calls for greater use of the case method are based on the belief that management is a skill that is more than the assimilation and

¹ Some instructors use the “case” label to describe examples or application exercises they use to illustrate points made in a textbook or lecture (for example, a depreciation calculation using actual company numbers or a practical application of regression analysis). Most case method instructors would not call these cases, and they would not call the use of these cases “the case method” because the teaching and reasoning process is deductive, not inductive.

² If this call is correct for teaching accounting, one of the most highly structured management functions, then surely it is correct for most, if not all, other management fields.

application of a set of structured techniques. Business people must make decisions regarding problems and opportunities arising out of new situations in a continuously changing environment. Case instructors believe that education should provide the facility to act in the presence of new experience. They believe, "It is not what you have been trained to know that is important; it is how you have been trained to think and act."

2. **Customized learning.** Cases require students to construct their own individual interpretations of the realities to which they have been exposed and their own workable approaches. Thus, case learning builds on the students' own individual backgrounds and perspectives. This is one reason the case method is particularly valuable for adult learning and why the case method has a dominant market share in executive education, where students have considerable experience on which they can build.
3. **Knowledge retention.** Since case learning is experience-based and anchored in reality, it tends to be internalized and to be retained longer than that obtained through lectures and readings.
4. **Development of skills of managing time and coping with ambiguity.** Cases help students learn to manage time and tolerate ambiguity. Like managers, they have to look at situations that involve multidimensional issues and, with tight time constraints, formulate credible action plans without complete information.
5. **Development of communication skills.** Case classes help develop the important skills of oral communication and persuasion, listening, and relating to others.
6. **Broadening of perspective.** Students are exposed to a variety of real business situations, in different functions and industries. This exposure gives the students confidence in interviewing and in early job experiences.
7. **Higher student motivation level.** Many students find cases more interesting to prepare than abstract readings, and they find the case discussion classes more interesting to attend than lecture/question classes. Thus learning is more fun, and the class's energy level is higher.

The case method is not a panacea, however. It has a number of weaknesses and limitations, including these:

1. The case method is **inefficient** for some forms of learning (as discussed above). Some students' reaction to early case discussions is: "Why don't you just tell us what we need to know, and we'll put it in our notes and learn it." In any field, it is true that some knowledge, such as facts and rules, can be neatly codified, so no course is or should be taught exclusively by the case method. Even instructors who are devoted to the case method lecture through some material or assign relevant readings when it is desirable to impart knowledge about specific theories or techniques.
2. The case method can be **frustrating** at times because what is learned is often personal, intimate and private. The instructor usually cannot tell students the "right" answers; they have to struggle with their own insights and attempt to make sense of the experiences with which they are presented.

3. The case method usually **requires greater effort** (for both students and instructors). Only the individual will know when they are “done.” Students usually find themselves changing their minds when exposed to others’ opinions (but that is a sign that learning is occurring).
4. The case method is **threatening** to some students. They find it difficult to think and participate in class, preferring instead to retain their old classroom habit of passive note taking.

However, because of the advantages listed above, the case method is widely used in schools of business, and its use is growing.

Suggestions for Student Preparation and Participation

Students have two primary duties in a case class: preparation and participation. To some extent, the style of case preparation is individualistic because the case problems are at most only semi-structured, and problem definition and evaluation skills can vary significantly across individuals. Nonetheless, here are some case preparation suggestions that many students find useful:

1. In preparing a case of more than a couple of pages, students should read the first few paragraphs, and then quickly scan the rest of the case (including the exhibits). This overview reading gives a feel for what the case is about and what types of analyses will be possible. The assignment questions also provide a guide to the major issues that will be discussed in class.
2. Then students should read the entire case carefully, underlining the material that is potentially most useful to the key issues or problems at hand. To improve understanding, some students find it helpful to translate text into visually-oriented diagrams, particularly where processes or procedures are described.
3. If assignment questions are given, students should try to answer them. The questions may ask for analyses, solutions, and/or action plans or may require finding or defining the problem. Students usually have to go back through the case to find the data needed to support their work. However, often the information provided in the case is incomplete, and the students, just like the professionals they are training to be, will need to make assumptions and inferences to fill the gaps. Students should try to recognize the assumptions they are making because that recognition may help them understand why other students reached different conclusions. In many cases, differences in assumptions are revealed during the class. Clarifying the assumptions before class starts helps in understanding the class discussion.

Sometimes, however, instructors do not provide assignment questions. This is because they are placing extra emphasis on the development of problem finding, definition, and formulation skills.

4. In the first three steps, students’ best results will come if they have worked by themselves. The next step is to for them to discuss the case with other students. These discussions will lead, almost invariably, to a broader perspective than that which any student could achieve individually. It may also uncover errors and will often lead to an improved set of assumptions, or at least a better understanding of the assumptions made.

With rare exceptions, the entire time spent preparing even a long, complicated case should not exceed three hours. Some diligent students may work much longer on a case, but this is rarely necessary, and it is often harmful. Spending excessive time on a case often causes the students to lose sight of the “big picture” (to “get lost in the trees and lose sight of the forest”). Further, these students are depriving themselves of the opportunity to develop their skills for rapid analysis and synthesis, skills that are critical in most fast-moving management jobs.

The classroom is a place for students to articulate a “point of view,” which includes analyses, conclusions, and recommendations, and to defend it. Good class participation involves a willingness both to share and defend ideas and to listen to what others are saying with an eye to expanding or challenging them. Interchange and constructive controversy lead to much of the learning in a case class. In addition to speeding the learning of specific course concepts, good class participation also enhances the development of skills of communicating, listening, thinking quickly (“on your feet”), and responding to questions under pressure.

It is easy for students to become so preoccupied with their analyses and thoughts that their mind becomes closed to the thoughts of other participants in the discussion. Just as in business, it is important in class to be open-minded and to be willing to shift positions. The measure of individual progress in any particular class discussion is not based so much on a student's own after-class assessment as to whether their ideas were “right.” Instead, it is more useful for each of them to ask: “How much did I take away from the class that I didn't know when I entered?”

Instructor Roles

The primary role of case instructors is to create an atmosphere conducive to learning. They direct the flow of discussion and record and organize the group's discussion as it emerges. They may also take a more interventionist role in the classroom by, for example, refocusing the discussion on a major issue that has not yet been well discussed, pointing out some of the more subtle issues, encouraging recognition of assumptions underlying a student's analysis, or playing devil's advocate when no other participant seems so inclined.

Sometimes the instructor will choose to summarize the case discussion, or even give a “lecturette” on materials related to the case. When this happens, the conceptual learning that can be so dull in a lecture classroom comes to life, as it is now informed by experience.

Students should expect their instructors to:

1. Know the case facts;
2. Come prepared with a teaching plan and a set of leading questions;
3. Listen to student comments;
4. Encourage all students to participate;
5. Exercise some control of the discussion. This will ensure coverage of the learning objectives for the class (or module) and balance the needs to bring out strong opposing viewpoints while giving every student the chance to become involved in the discussion;

6. Promote professional conduct, which includes, for example, the elimination of noisy side conversations and the disrespectful treatment of students whose participation efforts are earnest and sincere.

They should generally **not** expect their instructor to:

1. Be the focus of discussion. Instructor comments will generally be brief, nonjudgmental, nondirective, and often in the form of questions designed to keep the exchange of ideas flowing. Visual aids will rarely be used in the middle of a discussion because they tend to focus the discussion only on the content of the visual aid and omit other factors that may be as important or interesting.
2. Present definitive opinions or answers (unless only one answer is correct and the class was unable to derive that answer). The problem with revealing instructor comments is that students will usually focus on the instructor's solution/opinion and intellectually abandon their own prior analyses and opinions which may be equally or even more correct given their individual perspectives and assumptions.

Conclusion

As students become familiar with the case method, they see that the learning depends much more on interchanges between students (and sometimes the instructor) than it does upon individual study or subsequent enlightenment from the instructor. Preparation of a case, by itself, may not provide students with much learning, but it is a prerequisite for effective learning in the classroom.

Some students adjust instantly to the case method. They find the cases exciting to read and the case-oriented classes more stimulating than other, more traditional, lecture-style classes. Others adjust more slowly. They read cases and wonder what they are supposed to do with them, or they find the prospect of participating in class terrifying. Those who find themselves in this second group should keep trying. With enough effort, all students are able to enjoy the intellectual rewards that accrue from effective use of the case method.

Leo's Four-Plex Theater

Teaching Note

Purpose of Case

This case is intended as an in-class, “warm-up” case. It is particularly useful on the first day of class where students cannot be made to prepare a longer case prior to class. The case motivates the students (1) to think about the meaning of good control; (2) to consider a number of different forms of controls; (3) to think about the design vs. the implementation of the various forms of controls; and (4) to consider costs in their recommendations.

Questions

1. Where is the theater's control system lacking? Are the controls themselves weak or incomplete, or are the theater's problems caused primarily because of lack of discipline in using the existing controls?
2. What control improvements would you suggest for Leo's Four-Plex?

Analysis

I recommend starting the discussion by asking students to list the controls discussed in the case and the purpose of each. That will lead to the preparation of the chart shown in Exhibit TN-1. Then the discussion can move into the analysis of the problems and possible solutions:

1. *The cashier's collect less cash than the value of the tickets sold (or missing).* The common solution is to make the cashier pay for the shortage, or at least have shortages comprise a significant portion of the employees' performance evaluation.
2. Some refreshment stand sales seem to be lost because the attendants do not collect cash from the customers (perhaps their friends). There are several possibilities here. One is better

Professor Kenneth A. Merchant wrote this teaching note as an aid to instructors using the Leo's Four-Plex Theater case.

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direct supervision. Another is separation of duties between the person who rings up the sale and the person who delivers the refreshments to the customer. (The delivery would not be made unless the customer had a receipt.) A third is to hire more attendants from a different town because they would be less likely to know, and thus to collude, with the customers.

3. *Tickets of the wrong color or wrong date are found in the stub boxes.* The ticket-takers must be reminded of the importance of looking at the colors and dates, and they must be held accountable for implementing the control properly.
4. *The manager is giving away too many passes, including some for unacceptable purposes.* The pass policy must be clarified, and the manager must be warned not to abuse the privilege. If the manager cannot be trusted, then he should probably not be the manager. The owner could get involved in approving the issuance of passes, but this is probably more costly than beneficial.
5. The ticket collectors are apparently admitting some friends who had not bought tickets. Supervision, or even better undercover surveillance, is probably the best solution. If ticket collectors are caught, they should be dealt with harshly to discourage others from engaging in the practice.

Exhibit TN-1

Leo's Four-Plex Theater

Controls Used at the Theater and Their Purposes

Controls	Purpose
Color-coded and dated tickets	Ensure that the individual (4) theaters will not be oversold for any given showing.
Serial numbered tickets plus cash count	Allow reconciliation between tickets sold and cash collected.
Turnstile	Controlled access to theater. Allow for ticket collection.
Locked stub box	Allow for reconciliation between tickets collected and attendance counts.

Wong's Pharmacy

Purpose of Case

This case was designed to contrast with the Leo's Four-Plex Theater case. Like the theater case, it is intended as an in-class, "warm-up" case on the first day of class where students cannot be made to prepare a longer case prior to class. This case illustrates a strategic control (rather than a management control) problem.

Questions

1. What are Thomas Wong's options?
2. Would you characterize the Wong Pharmacy problems as *control* problems?

Analysis

Start by asking students what the problem is. Here it is a small pharmacy that apparently cannot compete with a larger competitor. There is no evidence of behavioral problems at the store level.

Then ask what Thomas Wong's options are. He can:

- Close the store or sell out;
- Move to a different location;
- Try to automate to cut costs (unlikely); or
- Try to find a survivable niche (e.g., different mix of products, superior service).

Finally, ask students if this is a control problem. Yes it is, but it is a *strategic control* problem, not a management control problem. These terms and the distinctions between them are discussed in Chapter 1 of the text.

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Private Fitness, Inc.

Teaching Note

Purpose of Case

This case describes a real-control problem faced by a small fitness-training business. A trusted employee was both stealing cash and, by not recording all sales, diverting some revenues to herself. Students find the setting interesting and easily understandable, but discussion of this simple setting helps students understand the range of control alternatives that firms can use. This is an important first step in designing a control system.

The case illustrates a common problem faced in many small businesses—lack of overlapping controls, or in this case what auditors call “separation of duties.” In addressing the problem described here, students can consider a broad range of control alternatives and their advantages and disadvantages.

Suggested Assignment Questions

This case was also used successfully as part of a final exam. The questions used were as follows, with the grading weighting used shown in parentheses. These questions might also be used to motivate student preparation for a class discussion of this case.

1. Describe a solution to Rosemary Worth’s control problem that emphasizes:
 - a. Results controls (20%)
 - b. Action controls (20%)
 - c. Personnel/cultural controls (20%)
2. What should Rosemary do? (40%)

Professors Kenneth A. Merchant and Wim A. Van der Stede wrote this teaching note as an aid to instructors using the Private Fitness, Inc. case.

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(You can choose one of the solutions described in your answer to Question 1, or you can combine particular elements of each of those solutions, if appropriate.) Explain why your recommendation is the best solution.

Discussion

Students must first recognize that there are two problems to be solved—the theft of cash and the unrecorded revenue. There are a lot of control options:

1. **Action controls**—For example, hire a supervisor, camera, locked cash box, use of receipts and reconciliations with cash in the drawer/cash register.
2. **Results controls**—This is a tough question. Students must recognize that providing Kate a bonus of, say, 10% of revenues or profits does little to reduce her motivation to pocket 100% of the revenue through theft of cash or direct pocketing of revenues. Revenue-based bonus systems could be effective motivators if Rosemary is sure that every client is recognized on the system, but by themselves they won't ensure that every client is recognized.

There are some more creative and better possibilities. For example, hold Kate accountable for the accuracy of the cash reconciliations, which is a result. Or set instructors up as “little entrepreneurs.” Let them keep **all** the revenue, but charge them a fixed fee for access to the facility.

3. **Personnel/cultural controls**—stricter hiring criteria (e.g., background checks), building a strong “family” culture, group rewards (which encourage mutual monitoring).

The answer to the question “What should Rosemary do?” requires consideration of the benefits (control effectiveness) and costs in this specific setting. Some alternatives, such as a camera, might be effective in tracking usage of the facility, but it is an expensive solution. A wide range of answers is possible here. Students should see that there is not just one solution to this problem.

The case also raises the question as to what Rosemary should do with Kate. Some students get emotionally involved in considering this issue. The answer to this question should be part of the control-system-design discussion.

Pedagogy

This is a short case. It can be used in class even if students have not prepared the case in advance. Most students can probably read the case in 10 minutes, and the answers to the questions can develop in the ensuing class discussion. With or without advanced preparation, the discussion can easily consume 45–60 minutes of class.

Atlanta Home Loan

Teaching Note

Purpose of Case

This case was written as an example of an extreme control failure. It can be used in a class focused on management control, entrepreneurship, or management of small businesses.

Al Fiorini, the manager of a small, but reasonably successful, mortgage lending company in Atlanta hired managers to run his business while he went back to school, for his executive MBA, in California. He did his best to monitor the company's operations while 2,500 miles away. But the managers not only stole from Al, they also stole his entire business! The case forces students to analyze the problems Al faced, to identify the controls that he had in place, and to suggest things he might have done to ensure that these problems would not have occurred.

Suggested Assignment Questions

1. Identify the devices (controls) that Al Fiorini used to control his business both before and after he went back to school. Classify each control as a results, action, or personnel/cultural type of control.
2. What went wrong? Did Al use the wrong types of controls? Did he use the right types of controls but fail to design or implement them properly? Or was he just unlucky?
3. What should Al do now? Why?

Case Analysis

These are among the questions that the instructor can use to stimulate the in-class discussion:

This note was prepared by Professors Kenneth A. Merchant and Wim A. Van der Stede for the sole purpose of aiding classroom instructors in the use of the Atlanta Home Loan case. It provides analyses and questions that are intended to present alternative approaches to deepening students' comprehension of business issues and energizing classroom discussion.

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1. How would you describe the Atlanta Home Loan (AHL) control system at the time Al Fiorini left for California?

Al used each of the major control types, as is shown in Table TN-1 below.

Table TN-1
Types of controls used by Al Fiorini

Results controls	Action controls	Personnel/cultural controls
Pay for performance: —loan officers —Joe's 50/50 profit sharing —Wilbur's 100% share, less a fee —telemarketers' bonus per lead produced (\$10 per lead)	Withhold authority to write checks	Personal judgments about people
	Monitoring of behaviors. Examples shown below.	Background checks
	Monitoring of emotional states by talking to employees on the phone	Trust
	Centralization of major decisions	
Performance evaluations, which could affect promotions and job retention. Bases for performance evaluations shown below.		

Examples of Al's monitoring of behaviors:

- Joe's attendance.
- He had all office mail forwarded to him in California.
- He monitored the status of loan applications submitted to lenders electronically.
- He knew what loans were approved and could calculate the amount of revenue due the company.
- He was monitoring the overhead in the office and was making sure it was in line with production. He used industry rules-of-thumb, such as one processor for every four loan officers. At one point Al sent a message to Wilbur telling him that the processor-to-loan officer ratio was too high. Wilbur countered with "Don't tell me how to run a business." At that point, Al was sure that he had a problem.

(Al did not have an electronic link to the processors' files, but he was trying to establish one.)

Examples of metrics that Al used to evaluate performance:

- Telemarketer standard measure of productivity = minimum of one lead per hour.
- Loan officers:

- Lead-to-loan application ratio. The range was 5–20%, depending on the experience of the loan officer.
- Number of credit reports requested.
- Loans funded. Each processor should be up to funding 20 loans per month (one per work day), plus open two new files per day.
- Fallout ratio (processed loan applications that do not result in a closed loan). The industry standard was 30%. AHL was doing better than this.

In the end, Al also used the ultimate control-problem “avoidance” approach—he shut the company down!

2. What caused the company’s problems? Were they failures in the company’s strategy or control system, or both?

Obviously this company suffered major problems. Al Fiorini lost money, and it appears he has lost his entire business. It is useful to clarify for the students that the failures were not caused by a flawed strategy. When Al Fiorini was running the company, the company was profitable, and it had significant growth potential. Thus, it is safe to conclude that the problems that arose were control problems.

3. Is it possible that Al Fiorini’s control system was good but that he was just unlucky?

This can happen, as control systems are never perfect. But just being unlucky does not account for most of the problems here.

4. What did Al do wrong?

With hindsight, it is clear that Al made a number of mistakes:

- a. He trusted people who should not have been trusted. He did not know his people well enough before he left for California. (Note, loan officers are not licensed in Georgia as they are in many other states, including California.) Could he have done better background checks? Would it have helped if he had started earlier to find a manager or partner to run AHL in his absence? But can personnel controls, by themselves, ever be completely reliable? Could Al have moved major portions of the loan process with him to California?
- b. He trusted the banks to fulfill their responsibilities. Bank of America (BoFA) should not have allowed Wilbur to release the stop payments on the checks. Citizens Bank & Trust (CBT) should not have allowed Wilbur to open a new corporate bank account.
- c. The results control arrangements were too easy to evade. Joe apparently quickly discovered that if he did not pass his loan applications through the company, he could earn 100% of the fee, rather than 50%. Al had no control over Joe’s loan application pipeline. He discovered the problems with Joe, but he might also have been having similar, undiscovered problems with the loan officers (i.e., diverting loan applications to other companies).

But how do you control this? Encourage whistle blowing, from someone like Leticia? Hire a company controller/auditor or another level of supervision, perhaps with two signatures required on almost anything? (The company is probably not large enough for this.) Better legal contracts?

Wilbur was clearly dishonest, and he eventually colluded with Leticia. Al relied on legal controls, which were evaded.

- d. The set of action controls was incomplete. Al should have gotten legal assistance earlier, instead of doing some things himself, probably starting with the partnership agreement. Perhaps Al needed a more elaborate set of policies and procedures, such as:
 - i. Don't take files home.
 - ii. Work at the office every day.
 - iii. Document your work.

But how can these action controls be enforced?

- e. When Al first became aware of the problems, he probably should have returned to Atlanta to straighten them out. But that would have been costly; it would have forced him to drop out of the MBA program.

5. Were Wilbur and Leticia crooks, or were they basically good people who were tempted to go bad by a weak control system?

In defense of Wilbur and Leticia, there was no evidence of prior problems. Leticia, in particular, had been loyal to Al. Maybe she was corrupted by Wilbur. But what eventually unfolded was an elaborate, clearly dishonest scheme that must have taken some planning. Therefore, one must probably conclude that Wilbur and Leticia were not totally honest people.

Can managers design control systems to protect themselves against dishonest people? Yes, it can be done, but it is hard to do when the person in charge is dishonest and the owner is 2,500 miles away.

6. What should Al do now?

Al must address two questions: (1) Should he fight for the business or just give it up? (2) Should he attempt to punish the crooks or just walk away? If a vote is taken, these questions will split the class.

The company is not worth much now, and the lawsuits are expensive to pursue. But it is tough to walk away from a business that had promise. Further, it is natural to have a revenge motive, to punish the crooks through criminal and/or civil cases. Al suffered major losses. He lost his AHL business, which he valued at \$600,000. He was unable to maintain his mortgage payments, so he lost his home in Georgia.

In reality, Al did fight back.

- He withdrew the license issued by the Georgia Department of Banking and Finance to limit the company's potential legal problems.
- He reported the crimes to the Atlanta police and the FBI, but no law enforcement agency ever showed much interest in pursuing the case. They seemingly considered it too small a case to bother with.
- He reported the bank failures to the banking regulators.

But Al never returned to run Atlanta Home Loan. There was not much left of the business. He estimated that he could reclaim about \$15,000–20,000 worth of equipment, and a

phone system worth about \$10,000. But the business pipeline would have to be rebuilt, and not much company goodwill remained, if any.

Al has started a new mortgage lending business in California, and it has gotten off to a successful start. He generates many of his leads through the website www.lowerrate.com.

Pedagogy

This case is quite easy to teach. The case itself is not difficult to read and understand, and most students find the situation inherently interesting. Thus, student preparation is generally good, and it is easy to get a good discussion going. With a typical MBA class, the optimum time for discussion of the case is probably around 45 minutes. In a longer class, then, instructors should be prepared also to give a mini-lecture or to discuss something else. We have used this case in the first class of a management control course, so an introduction to the course and the general topic of control fits nicely with this case.



University of Southern California

Marshall School of Business

Leventhal School of Accounting

A215-03 TN

Office Solutions, Inc.

Teaching Note

Purpose of Case

The focus of the Office Solutions case is the design of an incentive system for a sales force in a firm operating in the office supplies distribution industry. The CEO was unhappy with the company's current plan, which was primarily commission-based. He thought that kind of system was appropriate for just a few of his sales representatives who brought in new business, those whom he called "hunters." However, most of his reps were just servicing existing clients. He proposed a change in the company's incentive plan, providing different incentives for the two types of reps. However, he encountered resistance to the proposed change.

Suggested Assignment Questions

1. Evaluate the new approach for compensating the sales representatives at Office Solutions. In your critique, consider, at a minimum:
 - a. The recognition of the two different types of representatives
 - b. The performance measures
 - c. The performance standards
 - d. The forms, mixes, and amounts of compensation
 - e. Why some of the representatives are resistant to the change

What improvements would you suggest?

2. Would Office Solutions be better off if all of its sales representatives were good at "hunting"? If so, how should the company move in that direction?

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3. Should Office Solutions managers be monitoring the behaviors of the individuals in their sales force, or can they rely on the incentive system to motivate good behaviors?

Case Analysis

Critical Success Factors

Office Solutions competes with some industry giants (notably Staples and Office Depot), but it has found its niche and has been successful. It is useful to start the case discussion with an identification as to what the company has to do well in order to continue to be successful. Here is a short list of CSFs:

- Stick to its niche. It cannot compete head-to-head with the industry giants.
- Superior customer service, which requires attention to detail.
- Growth. Companies need growth to give employees opportunities to succeed. The most important driver of growth is finding new customers.

Description of the System

It is important for students to have a clear understanding of the current incentive system and its components. This will provide a framework to analyze the proposed changes to the system and to suggest improvements.

Performance measures: The most important measure by far is gross profit generated by sales reps customers. This measure is tracked and discussed monthly. It is used to calculate commission and bonus. Other measures used are revenue generated by sales reps' customers for three smaller product categories (used to calculate a small portion of the bonus). In addition, numbers of sales leads and the progression of those leads is tracked in the VFSS system and are used to manage activity.

Goals and the goal setting process: Goals are based on a target growth rate, and goals are set through a top-down process. However, managers spend time securing buy-in and commitment to the goals. The annual gross profit goal is broken down by month and by product category for tracking and to help sales personnel understand how it can realistically be achieved.

Performance evaluation: Because sales personnel are on a commission system, in a sense they are evaluated against their GP goal every pay period. They are more formally evaluated against their GP and VFSS goals on a monthly basis during sales meetings. Perhaps the most important evaluation is the annual evaluation, which is used to determine annual bonuses.

Financial compensation: Under the current systems, all employees earn 25% of the GP generated by their accounts as commission. Almost all of their compensation (more than 95%) is derived from this commission.

Sales personnel can earn another 0.4–0.8% of GP in the form of an annual bonus if they make their GP goal. The range is a step function that increases as the goal is exceeded, capping out at 0.8% of GP if the goal is exceeded by 20% or more.

Sales personnel can earn an additional 0.15% of GP for each of the three minor product categories, if they make their revenue goal for the category. This compensation also comes in the form of an annual bonus.

Other rewards or consequences: Students should be able to identify several controls other than compensation:

- Up front discussion and verbal agreement to goals
- Monthly meetings and monthly progress checks against goals
- Monthly discussion of progress against measures in VFSS (mentioned in particular as useful in correcting behavior before it materializes into low sales)
- Annual performance reviews
- Top performers recognized at annual sales meetings

Students may also note the absence of negative consequences for not making goals, aside from how it affects compensation. For example, there is no mention of employees being fired or demoted if they consistently fail to meet goals.

It is clear to Bob Mairena, and should be clear to students, that the current system is not effective. Bob has aggressive growth goals for Office Solutions. The current system is not completely aligned with those goals. Sales personnel do receive individual growth goals that are aligned with company growth goals, and they are evaluated against those goals during monthly meetings and performance reviews. However, a very small percentage of their financial compensation is dependent upon their achieving those goals. Sales personnel do not need to grow the business or even achieve their goals to earn the majority of their pay; they only need to continue to generate a steady gross profit. They can do that through some combination of retention, penetration and acquisition, but most focus on retention, presumably because it is easiest. A few focus on penetration and acquisition when it becomes necessary to replace lost customers/business. A few are true “hunters” who are motivated to grow the business, their own reputation, and their own compensation. But the current system does not adequately incentivize the sales force to aggressively pursue all three tactics to optimize growth. Even though the entire sales force is given growth targets, those targets are not strongly enforced and there is an unstated acceptance, reinforced by the compensation structure, that many sales personnel are only expected to manage existing accounts.

Assignment Question 1: Evaluation of proposal for change

The new proposal is to divide the sales force into two groups, account managers and sales representatives. Sales employees who bring in new business will be considered sales reps. Sales employees who bring in little to no new business will be considered account managers. Sales reps will remain under the current system, with the only proposed change being an increase in compensation. The mechanics of that increase is not defined. For account managers, the most significant change is in the area of compensation. There are no changes proposed to measures, goals and goal setting, or nonfinancial controls. However, financial compensation will change dramatically. Under the proposed system, 70% of an account manager's salary will be a fixed base salary, not dependent on achieving any goals. The remaining 30% of their salary will be variable, in the form of an annual bonus, dependent upon achieving annual gross profit goals as outlined in the current system.

The sales force is probably resistant to the change because their compensation will be significantly lower if they don't make their goals and earn their bonus. Bob wants to provide account managers with a more stable salary, but hopefully students will recognize that if the bonus makes up 30% of the salary, it is actually much less stable.

There are several other elements of the financial accountability control system for account managers that are not aligned with their new objective, retaining current customers and/or current gross profit. The class can discuss any of a number of potential improvements:

Measures: Students might suggest that since the sales force has limited influence on pricing and no influence on cost, sales volume might be a more appropriate measure than GP since that is what sales force has direct control over. However, GP is what company is interested in. Rewarding the sales force on volume alone would leave the company vulnerable to profit risk. Students may also suggest additional measures such as customer satisfaction or percentage of customers retained, that directly align with the new objectives for account managers.

Goals: The focus of discussion should be whether it is still appropriate to give account managers goals based on the same growth targets. Account managers will no longer be expected to acquire new accounts, yet there is no discussion in the case of lowering their goals. Additionally, the industry is shrinking, powerful new competitors are entering the category putting pressure on prices, account managers will presumably not be involved in winning new enterprise business, which is a key driver of growth. Students could make the argument that simply maintaining gross profit under these conditions is a goal more aligned with the newly defined responsibilities of account managers.

Evaluation: The only change to the evaluation process is timing. Under a commission structure, there is evaluation and accountability every pay period. Now, only the financial accountability is the annual bonus. Students could discuss the benefits of awarding bonuses every quarter instead of annually.

Compensation: This is where most of the discussion will probably take place. Students can discuss whether bonuses should be such a large percentage of an account manager's pay and discuss alternatives. For example, if Bob's objective is to provide account managers with a lower, more stable income, students may recommend 100% or close to 100% base salary, set at an amount lower than their current salary, but still high enough to attract new employees and entice existing employees to switch models. Alternatively, students may suggest keeping account managers on commission, but lowering the commission amount to 22% GP and eliminating the bonus. Others may suggest keeping the proposed structure but decreasing GP goal required to receive a bonus.

During this discussion, it would be instructive to challenge students to consider possible negative consequences for suggested improvements. For example, if students suggest lowering the bonus percentage and making the majority of salary a base salary, ask them what would happen under that system if an account manager lost half of their accounts.

Other rewards/consequences: Under the proposed system, the financial consequences for not making goals are so severe (will lose 30% of salary) that additional negative consequences may not be necessary. However, if students suggest lower goals and/or changing the compensation structure, then they should also consider additional negative consequences, such as firing employees who fail to maintain GP for some period of time.

Students should recognize that the challenge for Office Solutions is to develop a cohesive structure using all the elements of the control system that drives the desired behavior, in this case, retaining customers and current levels of gross profit.

Suggestions for Improvement

There are no plans to change the control and compensation system for sales reps so all the issues identified with the system remain; it still does not incentivize the sales force to optimize growth. There is still a discrepancy between the growth objectives and the lack of reward for growth (or consequence for lack of growth). The only difference is that now the only employees under the system will be those who have been identified as hunters. However, students should recognize that in addition to relying on the personal motivations and personalities of employees, there are opportunities to improve the financial control system for sales reps.

Measures: Students may suggest using GP generated from **new** business as a measure to evaluate sales reps (this measure is actually tracked by Office Solutions, although it is not currently used to determine compensation).

Goals: Students should recognize this as a key element of the control system that should be reevaluated for sales reps. Since the plan is to increase their compensation because they are bringing in new business, their GP goal should reflect their new job expectations. Office Solutions should consider making the goals more aggressive for sales reps and less aggressive for account managers.

Compensation: The bonuses for sales reps are so small that they are inconsequential. Along with more aggressive goals should come the potential to earn a much higher bonus. Since sales reps are expected to acquire new business, it is reasonable that they should expect higher rewards and a higher level of risk. Bob wants to increase their overall compensation so perhaps the bonus is the most effective way to do that.

Other rewards/consequences: Students should consider whether there should be consequences if sales reps consistently fail to acquire new business and explore alternatives. Perhaps a reason current employees want to stay on as sales reps even if they don't bring in new business, is that there is no downside. There are no consequences in the current system for failure. Students could argue that increasing the bonus goal and payment could act as both a positive and negative consequence. Students could also suggest adding other consequences such as the potential to be terminated or to be transitioned back to an account manager.

Assignment Question 2: Should everyone in the sales force be a "hunter"?

This question will generate heated discussion. Good arguments can be made in either direction.

One useful avenue for the discussion is in understanding the value creation potential of the three roles of the sales force:

Sales role	Type of Product	
	Office supplies	Other product categories
Retention of existing customers		
Penetration of existing customers		
Acquisition of new customers		

In which box in this table does the sales force create the most value for Office Solutions? Probably the lower right box. New customers provide the greatest potential for growth. They provide an additional revenue annuity for the company if they can be retained, and most can be retained. Margins in product categories other than office supplies are generally much higher than those in office supplies. Thus, hunting, particularly for customers who will buy a varied mix of products, is the most valuable thing that the sales reps can do. The company needs incentives slanted toward successful hunting to offset the sales reps natural tendencies to just live off their existing customers' purchases.

Some students will argue that all sales people should be required to grow the business if that is an important company goal, which it is. Bob certainly could design a control system that requires all sales personnel to aggressively pursue new business. He could fire employees who are underperforming and/or design a system that is so unprofitable for nonhunters that they quit.

However, students should recognize the risks inherent to that approach. First, it would completely change the culture at Office Solutions, which has a history of a positive work environment and long-tenured employees. Employee turnover could translate into loss of business in an industry still very dependent on customer relationships. Students should also recognize that not all reps are good at hunting, and managing existing accounts effectively is also vital to the success of the company. Recognizing the importance of both management and growth, recognizing and appropriately rewarding different skill sets, clearly stating job responsibilities, and developing distinct financial accountability control systems aligned to those responsibilities is a very good solution. Office Solutions is on the right track here.

Another complication: Bob Mairena realized that most of his older sales representatives, those over the age of 50, were not good at generating new accounts. Is this problem fixable, maybe through the compensation system, or should the company somehow find a way to employ only young reps? This question gets back to the culture of the company. Does the company want to push out the older reps as they lose energy and motivation? Some companies operate that way. If Office Solutions grows, some of the older reps could be promoted to manager levels. That would probably be the ideal solution, but the company cannot grow fast enough to create enough management jobs for all of them.

Assignment Question 3: Control other than incentives

Students should recognize that the sales force at Office Solutions is somewhat actively managed. Students can identify several controls that are not related to compensation. These include monthly and annual meetings at which goals and performance are discussed. These meetings enhance communication within the company and inevitably apply some social pressure for performance. In addition, the VFSS system enables the monitoring of some specific sales activities. Once Office Solutions has implemented the new compensation structure, will

they continue to need these other forms of control? Obviously, the more robust the compensation structure, the less necessary it will be to manage employee behavior with other controls.

It is theoretically possible that compensation alone could drive the desired behaviors. However, the performance measures are not perfect, and incentives often have some unintended consequences (such as gaming). Therefore, it is risky to rely solely on compensation. It certainly would not be advisable to eliminate other controls while a new compensation structure is being tested, although less active management could be a source of cost savings in the future.

Pedagogy

This teaching note has been written with the following pedagogy in mind; that is, clarifying facts about the company, its strategy, and both the old and the new incentive systems is important in getting the class started. Then, it is relatively easy to have the students discuss the rationale for change, the desirable sales force behaviors, the evaluation of the new system, and suggestions for improvement.

Puente Hills Toyota

Teaching Note

Purpose of Case

This case can be used to motivate discussions of a number of topics, including financial responsibility centers, performance measurement, transfer pricing, and incentives. The setting is an automobile dealership, a business about which all students have some interest and understanding. Moreover, the setting is real, so students can benefit from secondary learning about the industry and business.

Because the incentives provided in this company, and the U.S. automobile dealership sector in general, are quite substantive, a significant portion of the case discussion can be usefully devoted to examining and critiquing this company's performance measurement and incentive systems. However, Puente Hills Toyota has some features that, individually and in combination, make it different from most other companies described in cases that focus on incentive systems. This company is privately held; it makes use of some nonfinancial performance measures; it provides incentives to personnel well below the management level; and its managers are well aware that people are "playing games" with some of the measures.

The Puente Hills Toyota case can also be used in conjunction with the Kooistra Autogroep case study, which is also included in this textbook. Kooistra Autogroep and Puente Hills Toyota both are automobile retailers with highly similar organization and industry characteristics. However, that is where the similarities end. Kooistra Autogroep is based in the Netherlands where incentive pay is much less prevalent. Even though there is some evidence that even in the Netherlands companies begin to increasingly provide incentive pay, its advent is nonetheless controversial and not yet well accepted. Therefore, comparing and contrasting both cases (in one class or, alternatively, two separate classes) can lead to useful discussions about cross-cultural differences in the provision of incentives and in perceptions about the effectiveness of incentives.

This note was prepared by Professors Kenneth A. Merchant (University of Southern California) and Wim A. Van der Stede (London School of Economics) for the sole purpose of aiding classroom instructors in the use of the Puente Hills Toyota case. It provides analysis and questions that are intended to present alternative approaches to deepening students' comprehension of business issues and energizing classroom discussion.

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Suggested Assignment Questions

1. Evaluate the performance measurement and incentive systems used at Puente Hills Toyota. What changes would you recommend, if any?
2. At Puente Hills Toyota, most employees' variable incentive pay increases linearly with performance, however, performance is defined; that is, the higher the performance, the larger the bonuses that are paid. In most large companies, however, particularly at managerial levels, no bonuses are paid until a minimum level of performance, such as a budget goal, is exceeded. What are the advantages and disadvantages of using a reward/performance function like Puente Hill Toyota's?
3. (When used in conjunction with Kooistra Autogroep.) When comparing the use of incentives in the Puente Hills Toyota and Kooistra Autogroep cases, do you believe that incentive pay is truly effort-inducing; that is, drive employees to perform at their best? If you believe incentive pay is not, in whole or part, effective in making employees work harder, then what other potentially useful purposes does variable incentive pay provide for organizations relying on it, if any?

Case Analysis

Responsibility Centers

The case illustrates clearly that financial responsibility centers exist in great variety. While textbooks describe the possible generic responsibility centers as cost centers, revenue centers, profit centers, and investment centers, this case shows some of the variance that can exist within these generic categories. The general sales manager is held accountable for net profit. Obviously, the dealership also keeps track of balance sheet items, but the dealership general manager's incentives do not seem to consider them. So is the general manager an investment center manager?

Similarly, the departments are profit centers, but not all costs are allocated to them. They are more like "gross profit centers." The salespeople are held accountable for gross profit on the deals they initiate, so each salesperson is also a "little profit center." The service advisors are paid on commission, so each advisor is a revenue center. The service technicians, though, are paid for work accomplished.

It is useful to discuss why some seemingly uncontrollable indirect costs are allocated to departments (see Exhibit 3). These allocations are mandated by Toyota, so that they can compare dealership departments on a common basis that treats each department more or less as a stand-alone business. Allocating the costs also gives the department managers information as to what services are being provided for them and it gives them some power to complain if the size of the allocations becomes too high.

This issue can lead into a discussion of the differences between authority and accountability. Managers are generally held accountable for results in areas where they have authority. However, the general sales manager's bonuses are based on performance measured in terms of profit after overhead allocations (line 59 in Exhibit 3). This is an example of a situation where this manager is held accountable for areas over which he has less than full authority. Conversely, the service manager's bonuses are based on the department's gross profit performance, which is before allocations.

Transfer Pricing

Transfer pricing of service jobs done for internal customers (particularly the Used Car department) is done at market prices. The alternative would be to give the internal customer a discount, or perhaps even to transfer at cost. What would happen under that alternative? It would shift profits from Service to Used Car. It would also provide little incentive for Service to do internal work. Puente Hills Toyota transfers at market prices because they want to measure each department as a stand-alone business and they want to have the Used Car department get as much priority in the Service area as any other customer.

Performance Measurement

The measurement focus in this business is on profit measures. Do profit measures provide a good indication of value creation in the car retailing business? The answer here is probably yes. This is primarily a short-term business. Dealerships are not making many investments that involve large lags between time of investment and payoff (such as R&D), and they are not creating many intangible assets. The one exception is customer goodwill, so it is not surprising that Toyota mandates that considerable effort also be devoted to the measurement of customer satisfaction (CSI).

It is apparent in the case, however, that some of the measures can be gamed. Puente Hills Toyota managers worry about the gaming in the service area, and they seem to have adequate controls over these behaviors. The CSI measure is also gamed. But here the managers seem to “condone” the gaming because it makes the dealership look better to Toyota. Does the dealership need an un-gamed CSI measure for its own management purposes? How will they get accurate information about customer service problems if and when they exist?

Incentive Plans

Useful class time can also be devoted to a discussion of the structure of the incentive plans. Depending on the focus of the class and the class time available, the instructor can have the students complete an incentive plan matrix. On a whiteboard, list any or all of the key incentive plan elements. With adequate time, instructors can address the following:

- Eligibility (i.e., Who is included in the plan?)
- Form of payment
- Frequency of payment
- Measure(s) and their importance weighting
- Performance standards
- Shape of reward/performance function
- Size of reward (expected, maximum)
- Funding (e.g., Is there a company bonus pool constraint?)
- Uniformity (Are people in the same role treated the same?)

In an array of columns, list the roles for which the instructor wants to clarify the incentive system. In this case, these might include the general manager, general sales manager, service manager, salespeople, service advisors, or service technicians.

Among other things, this analysis will show that:

- The payments are all in cash.
- The payments are timely (monthly).
- The bonuses are paid by formula; there is no bonus pool constraint.
- There are no performance standards except in the service technician area where standards are set by Toyota. Internally set budgets are used to calibrate the payoff function, but goal-setting does not seem important in this business.
- The service manager reward/performance function is kinked upward to encourage beating the budget.
- The rewards are quite lucrative.

The **first assignment question** asks students for an evaluation of the performance measurement and incentive system, which requires them to identify good and bad points about it. In addition to the points raised above, students might mention the following:

- (-) There are no deferred compensation elements that might provide retention and tax benefits.
- (-) This is an incentive system that would require the company to pay sizable bonuses even if the company is losing money.
- (-) There is no bonus for teamwork. How much teamwork is necessary? The case mentions one area that could be improved—service referrals to sales.
- (?) Is the company paying too much? Answering this question would require knowledge of industry benchmarking. Some of these data are provided in the case Appendices. Puente Hills Toyota's practices seem in line with other dealerships.
- (?) The bonuses are all formula-based. Would it be useful to allow some subjectivity in case unforeseen events unfold or to reward otherwise hard-to-measure aspects of inherently multi-task jobs?

Generally, however, this measurement and incentive system probably must be considered as effective. Much of this system is dictated by Toyota, and this is an industry and company that has refined its systems over the years. Moreover, within the Toyota family, Puente Hills Toyota is a top performer.

The **second assignment question** asks students to evaluate the features of linear incentive pay increases with performance, as opposed to incentive schemes with a floor where no bonuses are paid until a minimum level ("hurdle") of performance, such as a budget target, is exceeded. "Kinks" in the function that relates incentives to performance (such as a floor (but also a

cap) on performance) create temptations for “gameplaying.”¹ Therefore, compared to kinked or *hurdle*-type incentive schemes, linear or *commission*-type incentive schemes remove these temptations. A potential disadvantage of linear incentive schemes, however, is that they also remove the motivational effects of performance targets. In other words, the company pays bonuses from the first dollar of profits earned (or sales booked) even though overall performance during the period may be poor or mediocre at best (i.e., profits or revenues fail to meet target).

Whether the benefits of removing gaming outweigh the loss of motivation due to removing targets depends on the situation. Employees can be strongly motivated by linear incentives schemes in situations where efforts, results, and incentives are tightly linked, as is likely for sales jobs (where the efforts of a salesperson can be directly linked with the sale) or production jobs (where the efforts of a shopfloor worker can be directly linked with the quantity and quality of output). In these situations, therefore, *commissions* (as they are typically called in a sales setting) or *piece rates* (as they are typically called in a production setting), strongly motivate employees to work hard to sell/produce *every* unit, whether the first or the last, regardless of where, or if, a target is set. In summary, given the nature of the sales environment in automobile retailers, Puente Hills probably can be said to reap the benefits of linear incentives through reducing the scope for gaming while still providing strong motivation to perform at any point in time during the performance period.

We address the **third assignment question** in the Teaching Note for the Kooistra Autogroep case study.

Pedagogy

As with most case classes, instructors must make a decision as to how structured to make the discussion. However, we recommend following roughly the same structure as presented in this teaching note to allow sufficient discussion time spent on all critical elements of any financial results control system, including responsibility centers (and transfer pricing), performance measurement, and incentives. To serve as an integration case, which this case provides an opportunity for, some structure is required as otherwise students tend to focus too quickly on the incentive system that undoubtedly tends to capture most of their attention when reading the case.

¹ For a more detailed discussion, as well as examples of the various “games” that managers play under kinked incentive schemes, see M. Jensen, “Corporate budgeting is broken—let’s fix it,” *Harvard Business Review* (November 2001), pp. 95–101.

Kooistra Autogroep

Teaching Note

Purpose of Case

The Kooistra Autogroep case describes a company that has expanded significantly from a small owner-run automobile retailer to a top-20 player in the Dutch car dealership market. To handle the growth, management is making an important transition from a primarily centralized organization to one that is becoming increasingly decentralized. This transition allows the case to be used to motivate discussions of a number of substantive issues, including the effects of an organization's growth and competitive environment on its organization structure and management control system design, advantages and disadvantages of decentralization, and design of control systems in decentralized organizations. Specifically, the case focuses on the design and implementation of budgeting, performance measurement, and incentive systems associated with changes in organizational design, in general, and the decentralization of organizational decision authority, in particular.

The case also provides some details about Kooistra Autogroep's early experiences with the new organizational structure and management control system design, thereby providing opportunities for students to suggest possible improvements, or even to consider abandoning the current pay-for-performance system, as some in the case suggest.

The setting is an automobile dealership, a business about which all students have some interest and understanding. Moreover, the case has some unique features. This company is relatively small (despite its recent growth), privately held, makes use of some nonfinancial performance measures, and provides incentives below the management level. Moreover, Kooistra Autogroep is based in the Netherlands where incentive pay is much less prevalent. Even though there is some evidence that even in the Netherlands companies are beginning to provide incentive pay, its advent is nonetheless controversial and not yet well accepted. This can lead to useful discussions about cross-cultural differences in the provision and effectiveness of incentives.

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The Kooistra Autogroep case can also be used in conjunction with the Puente Hills Toyota case study, also included in this textbook. Kooistra Autogroep and Puente Hills Toyota both are automobile retailers with highly similar organization and industry characteristics. However, that is where the similarities end. The incentive pay provided in Puente Hills Toyota, and the U.S. automobile dealership sector in general, is on average much larger than in Kooistra Autogroep or in the Dutch automobile dealership sector. This can lead to a discussion as to whether incentives are effective in driving performance, and if (not) so, why (not).

Suggested Assignment Questions

1. Did Kooistra Autogroep management go too far in decentralizing the organization? Did they not go far enough? Or did they get it just right? Why?
2. Evaluate the budgeting, performance measurement, and incentive systems used at Kooistra Autogroep. What changes would you recommend, if any?
3. (When used in conjunction with Puente Hills Toyota.) When comparing the use of incentives in the Puente Hills Toyota and Kooistra Autogroep cases, do you believe that incentive pay is truly effort-inducing; that is, drive employees to perform at their best? If you believe incentive pay is not, in whole or part, effective in making employees work harder, then what other potentially useful purposes does variable incentive pay provide for organizations relying on it, if any?

Case Analysis

Kooistra Autogroep was a family-owned automobile retailing company founded in 1953. Over the years, Kooistra grew from a small company that sold and serviced cars of only one or two brands from a single location to a top-20 player in the Dutch car dealership market. In early 2007, it owned and operated 13 dealership locations selling 10 brands of automobiles and employed approximately 325 people. Kooistra Autogroep grew primarily through acquisition of other small, owner-run dealerships in the southern part of the Netherlands. Economies of scale had become increasingly important due to economic and competitive pressures that continued to erode profit margins.

Given the growth and complexity of the business, the CEO (who is also part-owner of the company) had to consider delegating more operational autonomy to other managers, particularly dealership managers. With that, he also introduced a budgeting system, a performance reporting system that included both financial and nonfinancial information, and a pay-for-performance system for the company's dealership and department managers.

Decentralization

To address ***Suggested Assignment Question 1***, instructors can ask the students to list the advantages and disadvantages of decentralization.

The advantages of decentralization include:

- Freeing up top management time, allowing top management to focus on the most important decisions;

- Enhancing the ability for growth by developing the management team;
- Allowing quicker, more responsive decision-making;
- Reducing the distance between the decision maker and local information by giving authority to the managers who have the most detailed knowledge of their areas;
- Providing clearer responsibility and associated accountability;
- Making managers more cost conscious while being responsive to customer needs and market developments (local competition);
- Increasing motivation and commitment of subordinate managers who are now allowed “to run their own show.”

The disadvantages include:

- *Is top management willing to give up authority?*

The answer seems yes, as “Tom thought that the dealership managers should have substantial authority for the critical decisions in their business, including the hiring, firing, and supervising of their dealership personnel; advertising investments; sales promotions in their local markets; and price reductions that might be needed to move excess inventory or to meet the competition.” With the former owner, Tom Kooistra’s father, this would have been an issue, but Tom seems to embrace decentralization.

- *Are the dealership managers “salesmen” who lack the experience to be “managers”?*

Potentially an issue, although the car dealership business is mostly about making sales. There is no production, no R&D, and intangibles tend to be sales-oriented, such as through maintaining good customer service and providing employee training.

- *Is there a potential loss of economies of scale in key functions?*

Not likely. One could argue for economies in advertising, but advertising is brand-specific and sales promotions are geared to local markets. Kooistra Autogroep also maintained economies of scale in the service and body shop areas as well as in key corporate overhead departments.

- *Can some tough cost allocation problems be settled, such as for corporate overhead support functions?*

Currently not an issue as the dealership’s key performance metric, net profit, was defined as revenues minus “controllable expenses” and, thus, most corporate overhead allocations were “below the line” on which the managers focused. However, top management had the intent to improve its methods of allocating shared service costs to obtain more inclusive net profit numbers and, thus, to place more accountability at lower organizational levels. With that, some tough allocation problems obviously will have to be settled.

- *Will the dealership managers become too entity-focused and lose sight of the company's interests?*

Any change in organizational structure needs time to become fully operational. It is important to watch for signals suggesting control failures. These can occur in essentially two ways: poor *intra*-divisional performance (a well-designed performance measurement system should prevent that—discussed further in this teaching note) or failures to increase firm profits through *inter*-divisional cooperation (the risk is that dealership managers are myopically focused on their own entity results and fail to exploit synergies maximizing overall firm profit). While the latter failure—loss of synergies—is a potential risk, the scope for synergies across dealerships within this company is limited, however. Moreover, any business that potentially affects multiple dealerships is still handled at corporate, such as fleet sales and sales to rental car companies.

- *Is this too complex with unnecessary coordination issues?*

This mainly depends on whether or not good control systems are in place (see below).

Overall, the evaluation of the decentralization at Kooistra Autogroep should be quite favorable. The disadvantages/risks seem limited whereas the advantages/benefits of being able to manage the larger company while being responsive to economic and competitive pressures seem substantial.

That said, it is important to emphasize that decentralization gives rise to a fundamental control issue: How to make sure that employees (especially those who have authority to make important decisions) act in the best interest of the company? Measuring performance of subordinate managers and linking results to their compensation addresses this control issue. Therefore, decentralization has to go together with changes in measuring performance and compensating managers.

Performance Reporting

The measurement focus in this company for *incentive purposes* was on net profit for the dealership managers (see below). However, for *reporting purposes*, the company developed what they call a “balanced scorecard” on a weekly basis as well as monthly reports with more detail (line items). These reports included both financial and nonfinancial information.

There is not much to be commented on regarding these performance reports, other than that the reports were used as instruments to communicate the company's most important objectives to the dealership and department managers; to provide these managers with the information they needed to do their jobs; and to provide feedback to top management so that they could monitor the lower-level managers' performances. In other words, these reports put the needed information in the hands of the responsible managers to support their decentralized decision-making.

If they wish, instructors can comment on the use of the term “balanced scorecard.” Here the term is used very loosely. While it is true that the Kooistra reports contain both financial and nonfinancial information, the information is by no means organized in the “template” balanced scorecard measurement categories (financial, internal operations, customer, and learning and growth). Neither is it clear how each of the measures included “map into” the company's strategy and objectives. They may, but these links are by no means explicit. Is this so because

the car dealership “business model” is inherently simple? Or if it is complex, is it well understood by all?

Instructors can also note that the measures in Kooistra’s so-called “balanced scorecard” primarily include financial measures (sales and profits) and productivity measures. Do these measures provide a good indication of value creation in the car retailing business? The answer is probably yes. This is primarily a short-term business. Dealerships are not making many investments that involve large lags between time of investment and payoff (such as R&D), and they are not creating many intangible assets. The one exception is customer goodwill, no measure of which is—surprisingly—included in Kooistra’s “balanced scorecard.”

Does this imply that the Kooistra top management is ignoring an important value driver in their business? Not really. Customer satisfaction ratings are available and are considered by top management to decide subjective bonus awards, but they are not reported in the weekly balanced scorecards. The reason for their exclusion is, of course, that these measures are simply not available on a weekly basis.¹

Budgeting

Kooistra Autogroep also introduced a formal budgeting system, the main purpose of which was to set annual net profit targets for the dealerships. Budgeting was intended to be bottom-up, but due to the lower-level managers’ lack of experience with budgeting and their lack of formal business training, top management seemed to have the “last word” when it came to setting the final net profit targets. Perhaps because of this, several quotes in the case indicate that there might be a lack of commitment to the budget at least for some of the managers. Nonetheless, top management considered the budget targets to be “achievable with considerable effort.”

Instructors could also note that in this business top management may actually be quite well positioned to “impose” targets to a certain degree. Good historical data on sales and profits are available; there are industry data sources to benchmark performance; the business is quite stable year-over-year; the various dealerships within the company are quite comparable to allow some relative performance evaluation; and top management knows the business well.

Incentive Plans

Finally, Kooistra Autogroep expanded its existing bonus plan for salespeople and introduced a pay-for-performance bonus plan for dealership and department managers. Before this change, managers were paid on salary and were eligible for annual raises that were determined in large part by industry-wide negotiated “collective agreements.” Thus, before the change, virtually none of the compensation that managers received was merit-based.

Salespeople

Of the 45 salespeople at Kooistra Autogroep, only 25 were bonus-eligible because some of them had negotiated a compensation package without a bonus contingency when they were hired, sometimes at a dealership that had been acquired. Does this create “equity” issues? Possibly yes, particularly when the different compensation systems result in highly-varied compensation payouts within the same class of employees.

¹ Importers/manufacturers usually organize the customer satisfaction surveys. The frequency of these surveys varies by brand. Most brands conduct a survey every three months.

A bonus-eligible salesperson earns €18.50 per car sold. When the salesperson meets his or her monthly sales target (in terms of number of cars sold), the bonus amount is doubled to €37.00 per car for the month. On average, bonus payments are about 25% of salary for salespeople who meet their targets.

This bonus plan encourages sales, in units; not profitable sales. Is this consistent with the company's objective of maximizing net profits? The target feature even exacerbates the focus on unit sales as the bonus for the month is substantially lower if the unit sales target is not met. Does this cause salespeople to "push" sales for sales sake, regardless of the profit margin on the sale? Does it cause salespeople to "push" sales so hard at month end (when they are within reach of meeting the target) that it might hurt the customers' purchasing experience and customer satisfaction? In sum, this bonus plan seems ill-aligned with two of perhaps the most important company's objectives: profitability and customer satisfaction. Should this bonus plan be changed to incorporate other performance criteria, such as gross or net profit per car? The answer to this question seems almost certainly yes!

Managers

Target bonuses for dealership managers were set between 10% and 20% of annual salary. Target bonuses for department managers were set at eight% of annual salary. For dealership and department managers, the bonuses were based on the extent to which the managers met their annual net profit targets as set during the budgeting process. Only managers who met their net profit target earned their target bonus. No bonuses were paid for below- or above-target performance. Management also reserved the discretion to reduce any or all bonus awards (e.g., when customer satisfaction ratings were deemed too low), but such discretion had never been exercised.

In this bonus system, the managers earn their whole target bonus only when they meet target; they don't earn any bonus if they miss the target and they don't earn any extra bonus for overachievement. There is no "minimum performance threshold" (e.g., 80% of target) at which managers start earning a portion of their target bonus (e.g., 60% of target bonus). This means that the whole bonus rides on meeting target, which creates strong incentives for managers to meet the target (hopefully only through "legitimate" decisions, as opposed to "managed" performance).² This also implies that there is a strong *disincentive* to miss target by a tiny amount. Not meeting target by a small margin is as bad as not meeting target by a wide margin. This creates temptations to shift performance into the next period when the target for the current period is not met, which is also known as "taking a bath." Performance shifting into the next period is also likely for performance above target as no bonus is earned in this period for over-target performance. In sum, the bonus system is prone to encourage gameplaying behaviors due to the all-or-nothing target features of a "floor" and "cap" on performance at target.

However, do dealership managers have any leeway to shift income across evaluation periods? One might argue that they don't have much. Sales (revenues) are derived as customers come to the dealership when they come. While that is true, some carefully-timed sales promotions might shift sales from period to period. Moreover, dealership managers can certainly shift expenses across evaluation periods. They can, for example, postpone or accelerate maintenance, facilities upkeep, personnel training, and even hiring.

² For example, see M. Jensen, "Corporate Budgeting Is Broken—Let's Fix It," *Harvard Business Review* (November 2001), pp. 95–101.

Instructors may also raise the following questions. Are the bonus potentials large or lucrative enough to have impact? Is net profit the right measure? Should some portion of the bonus be based on overall company performance instead of being exclusively based on entity performance?

In summary, *Assignment Question 2* asked to evaluate the budgeting, performance measurement and incentive systems used at Kooistra Autogroep. Based on the above analysis, the answer to this question is mixed at best, and on some dimensions even poor, for the following reasons:

- The performance reporting may not be paying sufficient attention to a critical driver of performance in this business—customer satisfaction. Moreover, neither does the incentive system.
- There are potential issues of commitment to the budget, in part perhaps because the subordinate managers are lacking budgeting experience and business training. Budget targets are nonetheless very important for incentive purposes due to the all-or-nothing bonus target feature. Does this cause the managers to want to lowball their budget targets?
- The bonus plan for salespeople is limited in scope, including only 25 of the 45 salespeople at Kooistra Autogroep, thus potentially creating equity problems. The bonus plan for salespeople is also poorly aligned with the company's objectives of profitability and customer satisfaction.
- The bonuses for managers are exclusively based on net profit of their individual entities, and the bonus target feature is likely to induce gameplaying. Should there be a bonus for teamwork, such as by making some proportion of the bonus dependent on company-wide performance? (Perhaps not, as the scope for synergies is limited.)
- The bonuses are all formula-based, even though discretion can, but has not been, exercised. Would it be useful to exercise discretion in case unforeseen events unfold, when performance manipulation is alleged, or to reward otherwise hard-to-measure aspects of inherently multi-task jobs (such as, particularly, customer satisfaction)?

Early Experiences

The last section of the case quotes a dealership manager who opines that the company should abolish the bonus system for (department) managers, as he believes that the bonuses don't make the managers work hard(er). However, he also mentions that that might be due, at least in part, to the bonuses being too low to motivate. In other words, this quote suggests one of two possible courses of action: either abolish the bonuses or make them more substantive.

Top management, on the other hand, unequivocally embraces pay-for-performance, although they acknowledge that in the current system target setting remains an issue. (This is, as we have discussed, because the bonuses are completely predicated on meeting target, and so if the target is flawed (e.g., unduly hard to achieve), so will be the motivational effects of the bonuses.)

The case also mentions that pay-for-performance was a relatively unknown phenomenon in Dutch companies, although there is some evidence of its advent. Moreover, Exhibit 3 of the case provides some statistics about both the incidence and magnitude of bonuses in United States and Dutch car dealerships. The differences are stark.

With these opinions and facts in mind, **Assignment Question 3** was designed to motivate a discussion of whether incentives drive employees to perform at their best. Instructors can either have this discussion with reference to Exhibit 3 in the case or by specific reference to the Puente Hills Toyota case study.

Either way, instructors could point out that in Puente Hills Toyota (or the U.S. car retailing sector, on average), the composition of the compensation package is fundamentally different than in Kooistra Autogroep (or the Dutch car retailing sector, on average). In Puente Hills Toyota (the U.S. car retailing sector) a much larger portion of total compensation is variable, whereas in Kooistra Autogroep (the Dutch car retailing sector) total compensation almost exclusively consists of fixed salary with, sometimes (i.e., low incidence), a small portion of total compensation being performance-dependent.

Is this because Americans and the Dutch have fundamentally different risk profiles? Some quotes in the last section of the case would suggest that is indeed the case. However, the little evidence available does suggest only a relatively small difference in “uncertainty avoidance,” so this may not be driving all of the difference. For example, in Hofstede’s seminal study,³ the United States has an uncertainty avoidance score of 46, whereas the score for the Netherlands is 53—not a big difference. The United States, however, has a significantly higher score for masculinity (62) compared to the Netherlands (14). Masculinity involves a respect for agency and achievement, which is clearly consistent with a system that links pay to performance.

Beyond national culture differences, there are other possible drivers of the observed differences in pay-for-performance practices across both companies (countries). Instructors may solicit from the students what they think these might be. The list could include differences in income taxes, laws and regulations, unions, and industry practices; the influence of compensation consultants; or perhaps just fundamentally different views of “model of man,” such as whether employees are viewed or treated as *stewards* or *agents*.⁴

Finally, and specifically with respect to difference between the bonus plans of the two companies, instructors can note that the bonus plans for managers at Puente Hills Toyota is akin to a *commission*-type bonus scheme, meaning that the managers will almost certainly earn some bonus; whereas at Kooistra Autogroep the bonus scheme is akin to a *hurdle*-type plan, meaning that the managers only earn a bonus when the target is met, making it more likely that no bonus is earned (thus imposing more risk on the managers).

Apart from discussions about the differences in situational factors that might help explain, or at least provide clues about, the observed differences in incentive practices across both companies (countries), instructors can also ask students’ opinions about whether or not they believe incentives work; that is, do they make employees work harder? We suggest letting this discussion flow freely with students perhaps arguing mostly among themselves with little intervention by the instructor.⁵

³ G. H. Hofstede, *Culture’s Consequences* (Beverly Hills, CA: Sage Publications, 1980).

⁴ Instructors may find the following article particularly insightful to help sort out this discussion: M. Beer and K. Nancy, “Do Incentives Work? The Perceptions of a Worldwide Sample of Senior Executives,” *Human Resource Planning* 26, no. 3 (2003), pp. 30–44.

⁵ Instructors may find the following article particularly insightful to help sort out this discussion: A. Kohn, “Why Incentive Plans Cannot Work,” *Harvard Business Review* 74, no. 5 (September–October 1993), pp. 54–60.

To conclude, instructors can point out that incentive pay can serve any or several of many purposes, including:

- **Attraction/retention of employees.** Paying employees only guaranteed salaries tends to attract risk-averse employees. Paying performance-dependent compensation tends to attract employees who are more risk tolerant, more aggressive, or more confident in their abilities. What type of employees does a car dealership want? (Tom Kooistra seems to believe he would like more of the latter type.)
- **Motivation.** Motivation has two elements. One involves *inducing effort*, getting employees to work hard. The other is *directing effort*, helping employees understand what is expected of them. In the case of Kooistra Autogroep, the induction of effort seems not to be a problem, at least according to some of the quotes in the last section of the case, although Tom Kooistra questions that premise. However, Tom Kooistra also believes that he needs to inform and remind employees about what is important for the company to succeed. Thus, this is another important purpose of the new bonus system.
- Finally, **pay-for-performance makes at least some portion of the compensation expense variable with company performance.** Given the eroding margins in the Dutch automobile sector, this may be another feature of introducing bonuses at Kooistra Autogroep; it makes compensation expense higher (lower) when the company can best (least) afford it.

Houston Fearless 76, Inc.

Teaching Note

Purpose of Case

This case describes a sales incentive system based on a traditional commission payouts and a proposal for change. The proposal raises a number of issues regarding performance measurement, performance standards, and calibration of incentive awards. One interesting part of the proposal is a “truth-inducing” feature designed to motivate the salespeople to make accurate sales forecasts. An interesting unsolved issue is whether to and how to provide incentives for selling products with negative gross margins, which the company still wanted to sell for strategic purposes.

Suggested Assignment Questions

1. Why are Houston Fearless 76, Inc. (HF76) managers unhappy with the company’s existing sales incentive plan? Are weaknesses in this plan a major cause of the company’s performance problems?
2. Evaluate the new incentive plan being contemplated. What modifications would you make to the proposed new plan, if any? How would you address the unresolved issues?
3. Are there any significant impediments to the successful implementation of the new incentive plan? If so, which?
4. Would you make any changes to the system providing bonuses to sales assistants? If so, what?

Professors Kenneth A. Merchant and Wim A. Van der Stede wrote this teaching note as an aid to instructors using the Houston Fearless 76, Inc. case.

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Case Analysis

What does HF76 want from its salespeople?

Before getting into a discussion of the old and new sales incentive plans, it is useful to have the students clarify the company's markets and to identify the behaviors that HF76 managers would ideally like from their salespeople. HF76 is organized into four business units: HF International, Extek, Mekel, and Pollution Control Systems.

- a. HF International (photo processing)
 - Mature market
 - Known customer base
 - One salesperson in the East (lives in Maryland).
 - Sell through distributors in the West.
- b. Extek (micrographics)
 - Mature market
 - Customers are government entities
 - 125 dealers
 - One salesman working in a specific market (lives in St. Louis). He also has the task of culling the dealer list. (Where is his motivation for that?).
- c. Mekel (scanners)
 - More high tech, more growth potential
 - Two salespeople; 1 domestic, 1 foreign.
- d. Pollution control systems
 - Only one sale to date
 - One salesman with little sales experience
 - Company sees this market as having great potential.

What does HF76 want its salespeople to do?

- Provide good service to existing customers. This is particularly important in the mature markets.
- Allocate their time effectively, particularly to sell in the most profitable markets.
- Find good new customers and to open new markets.
- Provide accurate sales forecasts.

What should be the goals of the sales incentive system?

- Motivation (stimulate effort)

- Direct attention (communicate what is important)

An incentive system is imperative in this setting. Because of the geographical dispersion of the sales force, close monitoring by management (action control) is not feasible.

What are the key elements of the existing sales incentive plan?

Because of the complexity of this, and actually most incentive plans, we suggest laying out the features of the old and proposed plan in a structured manner. We have outlined the major elements of both in Figure TN-1. (This format is useful for summarizing the elements of the incentive plans in many cases.)

What are the problems currently being faced?

- Dealers and sales reps do not share customer lists.
- Salespeople are not developing new customers. Most of them merely respond to inquiries.
- Salespeople are spread all over the country. The VP-Sales is in Atlanta. The organization is hard to control/monitor.
- The salespeople have not received performance evaluations recently, or raises.
- Sales tracking is just being computerized.
- The sales forecasts are inaccurate. Can they be made more accurate?
- The company is paying commissions whether the salesperson causes the sale to occur or not.

What are the key elements of the proposed incentive plan?

See Figure TN-1.

It is useful to clarify the shape of the performance/reward function. The slope of the payout function in the existing system was 2–4% of sales. The slope of the function in the proposed system is much steeper. No bonuses are paid for the first sales, up to 70% of forecast, and then the kinked function goes up sharply. The company managers reasoned that the first 70% of sales would occur anyway, even if the salesperson was lazy. Therefore, the incentives for the sales force to sell a lot have increased markedly.

These slopes can be illustrated with a hypothetical example. Here is one that can be used:

Assume a high margin sale = 30% GM

Price = \$100,000 (a scanning system)

Commission rate = 2%

Assume that plan = \$1.6 million sales

$$= \$1.6 \times .3 = \$480,000 \text{ gross margin}$$

Under the old plan

Commission on the one sale = \$2,000

GM for company = \$30,000

At plan, company GM = \$480,000

Salesperson earns \$32,000

Under the new plan

At 70% of plan (\$1.12 M in sales): Company GM = \$336,000

Salesman commission = 0

At 100% of plan (\$1.6 M in sales): Company GM = \$480,000

Salesman commission = \$35,000

Slope = $35k / (1.6 \times .3) = 7.3\%$

On \$100,000 sale > 100% plan: Company earns \$30,000

Salesperson earns \$9,100 (slope = 9.1% of GM)

Evaluation

Students should be asked to evaluate the plan and to provide recommendations for improvement. There are a lot of issues that can be discussed. Students will raise most of the obvious measurement and calibration issues. A good student report on this case is appended to this teaching note.

Here are some other questions that can be posed if they do not come up naturally:

- Is the weighting of the three aspects of performance correct? Is this enough incentive for forecast accuracy or for the individual MBO items? (It seems small.)
- Does the start-up business (pollution control) fit this plan? (No.)
- How should HF76 provide incentives to sell products that are sold at a negative gross margin? HF76 had a number of these products, which managers wanted to keep selling for customer access and service reasons. This is a difficult issue that HF76 managers had not solved. Any of a number of approaches could have been used, such as guaranteeing the sales force a minimum gross margin percentage on each sale.

Other, perhaps more peripheral, questions that can be posed, time allowing:

Should anything have been done with the incentives for the sales assistants?

This aspect of the plan does not seem to have any motivational value. On the other hand, it is not expensive. Perhaps the value of this part of the plan is as a wealth-sharing feature. It makes the assistants' total compensation slightly variable with overall results. This feature allows the company to pay the sales assistants more when it is able to do so, and it allows them to save cash when times are tightest.

Should HF76's managers have been satisfied with measuring and providing rewards for profits on sales down only to the gross margin line, rather than down to a "bottom-line" product profit figure?

The sales people do not control much below the gross margin line (only their selling expenses). Still, ideally incentives should be based on full cost numbers and even, possibly affected by information about the profitability of particular customers. If the costs below the gross margin line vary across products, this information and the associated incentives can change the salespeople's focus. However, HF76 is a small company. It does not have in place the sophisticated cost system necessary to provide this information.

What the Company Did

The company presented the proposed plan to the sales force and met with unanimous and strong objections. The top managers decided that the change was too radical, so they backed off on their plan to make the change. Instead they modified their old plan. They left the old commission plan in place, but they added three extra rewards. One was an extra bonus of 5% of salary if total year-end sales were within plus or minus 10% of the sales forecast. The second was an extra bonus of up to 3% of salary if the salesperson achieved a set of MBO-like objectives. Moreover, the third was an extra bonus of up to 3% of salary if the salesperson kept travel expenses within the planned limits. The company wanted the salespeople to be motivated to search for lower fares and cheaper hotels.

These changes are described in the *Houston Fearless 76, Inc. (A): The Aftermath* case appended to this teaching note. In addition, appended is the *Houston Fearless 76, Inc. (B)* case, which provides information on the company from January 2002, a year later than the (A) case. These cases provide information that the instructor can give to the students at the end of class. Alternatively, to save time, one of the cases can be handed out at the end of class.

Pedagogy

This case contains a lot of issues that can be discussed. Thus, the instructor will have to provide some structure to the discussion to ensure coverage of the issues deemed most important. The discussion above presents one possible structure. If that structure is used, the class timing could be approximately as follows:

1. The company and the salesperson role	10 minutes
2. The existing incentive plan	5
3. Problems with the existing plan	10
4. The proposed incentive plan	15
5. Evaluation and suggestions for improvement	30
6. What the company did	<u>5</u>
Total	75 minutes

Figure TN-1

Key Features of the Existing and Proposed Sales Incentive Plans

	<i>Existing Plan</i>	<i>Proposed Plan</i>
<i>Who is included in the plan?</i>	Salespeople	Salespeople
<i>Form of payment?</i>	Cash	Cash
<i>Frequency of payment?</i>	Monthly	Annual award, but monthly advances at 80% rate
<i>Measures and weighting?</i>	Sales (100%) (Shipments within assigned territory)	<ul style="list-style-type: none"> - Product gross margins (83%) - Forecast accuracy (extra 5% of salary) (8%) - Achievement of MBO targets (extra 5%) (8%)
<i>Performance standards</i>	--	Salesman forecast of gross margin
<i>Reward/performance function?</i>	Linear	<ul style="list-style-type: none"> - Zero up to 70% of GM forecast - 25% higher slope > 100% of forecast
<i>Size of reward?</i> <ul style="list-style-type: none"> - Expected - Maximum 	<ul style="list-style-type: none"> - 50% of base salary - none 	<ul style="list-style-type: none"> - 60% of salary? - none
<i>Funding?</i>	As necessary (no bonus pool or corporate constraint)	As necessary
<i>Uniformity across company?</i>	Yes	Yes

Houston Fearless 76, Inc. (A): Aftermath

On November 25, 2000, James Lee proposed the new plan in the annual sales meeting. Salespeople all voted against the plan, particularly the idea of replacing the sales-based commission plan with a profit-based bonus plan. Here are some quotes from salespeople:

I understand that firms need to generate profitable sales and cash inflow. However, why should we salespeople be held accountable for profitability? If the product is unprofitable, that was caused by top management's pricing decision, or their decision to keep the product offering.

.....

Historically, HF76 has not had a good cost accounting system that could track accurately the costs incurred to make a specific product. How can I trust that the profit number is correct for the products I have sold?

.....

We all understand that, from an operations perspective, more accurate forecasts are always preferred. However, given the nature of capital products, accurate forecasts are difficult even if you work with customers closely. You know sales are going to happen but you just do not know when. A sudden cut in the customer's budget would delay the purchase. Forecasts are just a best guess. Tying commissions to targets would probably just make us to forecast more conservatively.

Because of the opposition from the sales force, James and M.S. Lee pulled back from their intention to implement the new, proposed sales incentive plan. In January 2001, they implemented a new sales incentive plan that was dramatically different from the proposed plan. The final incentive plan made only minor changes to the existing commission plan. Salaries and sales commission rates remained unchanged.

However, the new compensation plan provided **extra** rewards, on top of the existing commission structure, in the following ways. First, salespeople could earn 5% of their salary if

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total year-end sales were within plus or minus 10% of sales forecast. Second, salespeople would earn an extra 3% of salary if they achieved each of the goals in a set of MBO targets negotiated by management and salespeople. Finally, a maximum of 3% of salary would be awarded if total year-end travel expenses were kept below the approved travel expense plan.

About the new plan, James Lee explained:

This is the first step in moving our sales force to even think about other objectives beyond sales. HF76 has always had the culture to make sales, even if it meant selling at a loss. This new plan at least provides salespeople with incentives to improve forecast accuracy and to address some of the firms' strategic needs. More importantly, our salespeople liked the plan. Getting sales people committed and motivated is the most important issue.

However, James also realized that his attempt to revamp the sales incentive system based on his original idea was largely unsuccessful. He reflected:

The fate of the new plan is not totally unexpected, although it is disappointing. I noticed that the sales personnel were against the new plan from the very beginning of our meeting. There are some good reasons for their opposition. For example, moving toward a profit-based incentive system would require a relatively accurate cost system, and we do not have one in place. Technically speaking, revamping our cost accounting system is feasible. However, I was quite surprised to hear how low our accounting department's credibility is among our sales force. [Our VP-Marketing] was very concerned about whether the accounting department could even record their sales commissions correctly. In addition, HF76 has a wide range of product lines with different profit margins. It could be too complicated to figure out how to set the appropriate parameters to maintain fairness and to communicate our product market strategy. More important, profit-based incentive would affect every dimension of our organization. A profit-based system would imply that my father had to refrain from intervening in pricing decisions. A profit-based system would also give too much power to sales to decide which product to sell and which not to sell. The danger is that we might lose control of our overall product market strategy.

Ideally, I want our firm to move swiftly in the new direction. However, we have to realistically consider the organization's ability to absorb significant changes in a relatively short time period, especially for an organization without changes for so many years. We had to make a choice between losing our salespeople and changing our proposed new plan.

Houston Fearless 76, Inc. (B)

In January, 2002, M.S. Lee, President/CEO of Houston Fearless76, Inc. (HF76), expressed some optimism about the changes that had occurred at the company:

We used to have overly optimistic sales forecasts, but now I feel they are more realistic. Two salespersons met their forecasts and will receive a bonus, and the others have some work to do for 2002. I could tell they paid attention to certain things including travel and expenses, and two salespersons will get their travel and expense bonus. We placed heavy incentives on Bob Smith, Vice President-Marketing, and he achieved 51% of his revenue goal. Mark Fogarty's (pollution control) compensation was changed to 4% commission on pollution control sales, but no units were sold commercially in 2001.

Overall, I think we have a better handle on sales, except in pollution control, but we are facing much larger challenges right now. Since we obtained the Fujifilm distribution agreement in September, the dynamics of the company have changed. We need to reorganize the company, and I want an effective organization to get things accomplished.

On August 13, 2001, HF76 and Fuji Photo Film U.S.A., Inc. (Fujifilm) announced that HF76 obtained an exclusive distribution agreement for Fujifilm's micrographics products for the United States and Canadian markets. Ken Kopald, then Vice-President and General Manager of Fujifilm U.S.A.'s document products division also announced that he will be leaving Fujifilm after 29 years of service and join HF76 as President of Ascendant Solutions International (ASI), a subsidiary of HF76:

ASI is now responsible for sales, marketing and service of all HF76 document imaging products (including Extex duplicators, Mekel scanners, and HF processors) and Fujifilm chemistry, film and other related products. We will also add products from other vendors if a good business opportunity exists. ASI will integrate former Fujifilm salespersons and service technicians, integrate them with HF76's sales and service force, and form a sales and service organization organized by regions allowing them to cross-sell all HF76 and Fujifilm micrographics products. We have an excellent

James Lee, an Executive MBA graduate, and Professor Larry Greiner wrote this case as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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opportunity to bundle the consumables with the equipment, and integrate both customer lists from Fujifilm and HF76.

Ken Kopald built from scratch his sales and service organization at Fujifilm U.S.A., which grew to 30 employees involved in sales, customer service, and technical service. As the microfilm industry matured and with the advent of digital imaging technologies, revenue declined. However, the industry is expected to level as microfilm becomes more narrowly defined as a long-term archiving medium. With total HF76 revenues at \$14M for 2000, the addition of the Fujifilm business will significantly boost company revenue. Although profit margins are lower on the film and chemistry consumables, analyses showed potential profits. In the preparation of forming ASI, several budget meetings were held and budgets were formulated going forward.

As Ken developed the transition plan, he adopted the sales compensation structure (base salary, commission, MBO targets, and Forecast Bonus) that HF76 had implemented in 2001 for three reasons: (1) simplicity, (2) familiarity, and (3) flexibility.

The plan is relatively simple but communicates much more than just a base salary and flat rate commission. Also, our former Fujifilm sales staff was already used to a similar plan at Fujifilm. And, we can shape direction by boosting commissions for the more profitable products such as scanners and duplicators. We also weighted the compensation more heavily on the commissions. We needed to be more equipment-oriented so we took the HF76 weighting of about 40/60 (base/commission) instead of the 60/40 we had with the more repetitive film and chemistry sales.

Company Performance

As of late January, financial statements for 2001 were not available from the Accounting Department. Sales performance for recent years and projections through 2003 are provided in Exhibit 1.

Growth Challenges

The number of sales transactions has increased ten-fold and several departments have experienced growing pains. Before ASI, HF76 would process 5 to 10 orders per day for spare parts or custom-built equipment. Now, HF76 is receiving 40 to 70 orders per day for film and photochemicals our customers typically want the next day. M.S. Lee remarked, "We have changed from a manufacturing company to a distribution company overnight. Several other areas need to change, too."

A New Organization

A new organization (Exhibit 2) was being contemplated by M.S. Lee. "We have all this good business, but we have problems executing our goals. I currently have too many people directly reporting to me. I need to cut that number to 5 or 6 instead of the 11 I have now."

Exhibit 1

Houston Fearless 76, Inc.

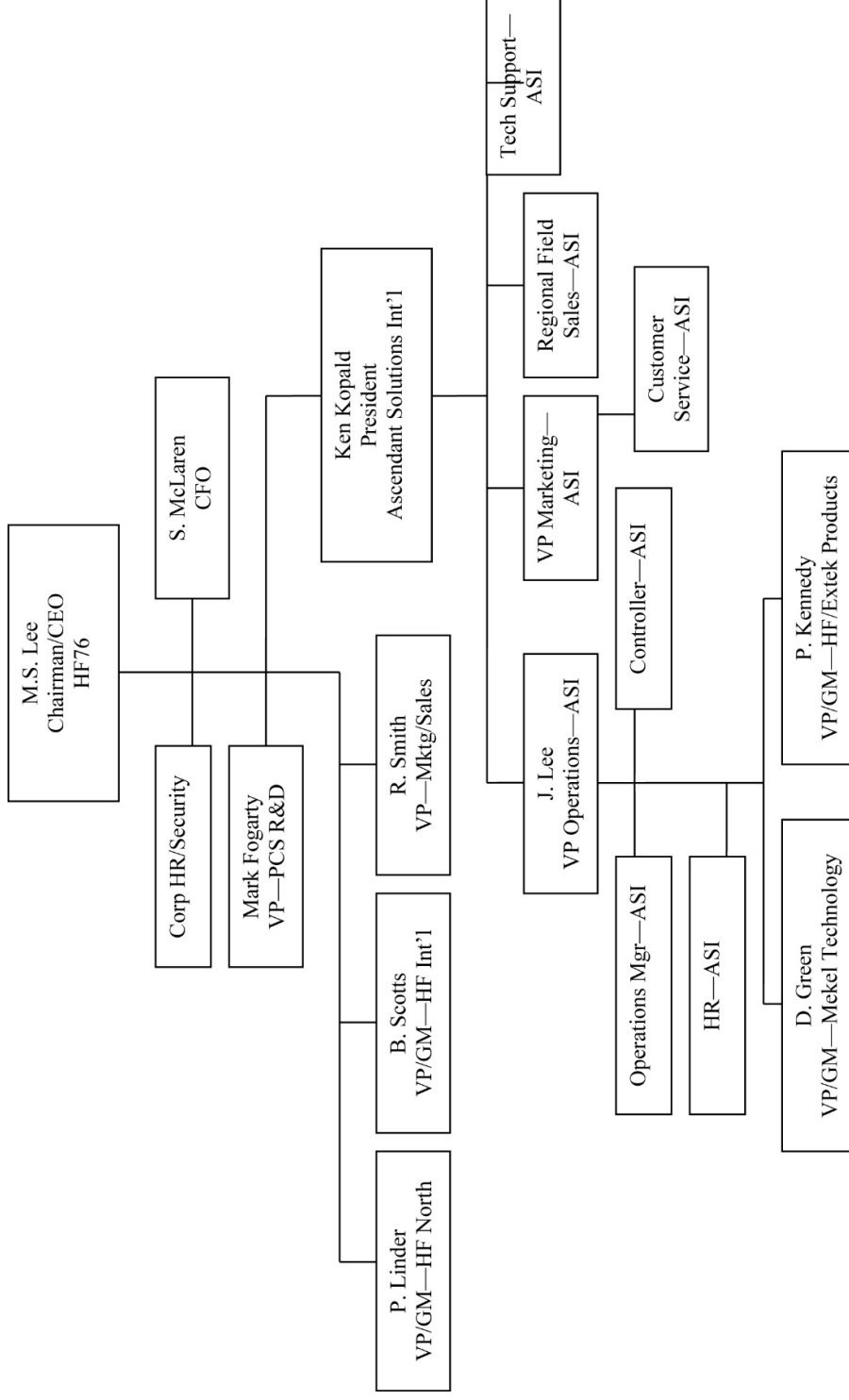
Sales History

	2000		2001		2002		2003	
	(Actual)	%	(Estimated)	%	(Forecast)	%	(Forecast)	%
Government	5,477,503	40.7%	4,773,444	26.7%	4,725,000	15.8%	4,961,250	14.5%
Commercial	7,977,520	59.3%	13,114,642	73.3%	25,180,000	84.2%	29,204,600	85.5%
Total	13,455,023	100.0%	17,888,086	100.0%	29,905,000	100.0%	34,165,850	100.0%

Exhibit 2

Proposed Reorganization—2002

Houston Fearless 76, Inc.



Houston Fearless 76, Inc.

Teaching Note

Addendum: Student Exam Assignment and Report

Below is one relatively representative example of a student analysis of the Houston Fearless 76, Inc., (HF76) case as an exam assignment. We show the exam rules, the assignment questions, and then the student exam report.

Exam Rules

1. Next week's midterm exam will be **take-home**. It will consist of a case similar to the cases analyzed in class. I will post the exam case and the assignment questions in the class folder exactly 48 hours before the exam submission deadline.
2. The exam can be done individually or in groups of up to three people. Groups will have to monitor and manage themselves. All members of the group will receive the same grade on the exam. ***It is your responsibility to ensure that your name appears on the group's submission.*** Once you have formed a group, you may discuss the case with members of your group only and *not* with the members of *other* groups.
3. Case reports (individual or one per group of three students maximum) must be e-mailed to me by the scheduled exam deadline. ***Late assignments will not be accepted and will result in a missing grade for the exam.***
4. I will not answer any questions regarding the exam to avoid (perceptions of) unfair treatment by students who ask questions and those who don't. (No phone calls. No e-mail. None. Zero. Period.) If you make assumptions (by lack of information in the case study or other), just state them clearly and *justify them*.
5. Please make a comprehensive analysis to support your answers to the assignment questions, but papers should be as concise as the subject matter and analysis permit (four pages

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maximum). The questions require answers consisting of complete sentences—not one-word answers. Bullet points or outlines are acceptable as long as they are properly tied into your answer to the question and the totality of your answer is comprehensible. The reports are to be typed in 11-pitch font, single-spaced, with one-inch margins on every side. (*These are not exercises in creativity with page layouts.*) The **four-page limit** does not include supporting exhibits, which should be kept to the necessary minimum. Grades will be based on soundness of analysis, application of relevant principles, and clarity of exposition.

6. If you cannot comply with the exam deadline or any other exam rule spelled out above, you need to contact me as soon as possible, but certainly ***before I post the exam***. I will maintain a tough stance toward exceptions, such as a request for an extension of the exam deadline, for the following reasons:
 - a) This is a *take-home, open-book, open-note*, “open-everything” exam.
 - b) You have *two days* (48 hours) to complete the exam.
 - c) You are reading these instructions now, thus, up to about one week before the actual exam is posted. This should give you enough time to schedule a block of time in your calendar to work on the exam.
 - d) The exam case and questions will be made available in *electronic format* in the class folder, and the exam should be e-mailed back to me. Thus, the exam is accessible anywhere at any time, and physical presence at USC is not required to complete the exam.

Assignment Questions

Case Background

The Houston Fearless 76, Inc. (HF76) case study discusses a proposal for change in a sales incentive program. The new program is interesting for a number of reasons, including a proposed shift toward rewarding the generation of profits (actually gross margins), rather than just sales, and a “truth-inducing” forecast incentive feature.

Case Questions

[Q1 = 30 points/Q2 = 30 points/Q3 = 30 points/Q4 = 10 points]

1. Evaluate the old incentive plan as well as the new incentive plan being contemplated. Are there any significant impediments to the successful implementation of the new incentive plan? Which?
2. Should HF76’s managers have been satisfied with measuring and rewarding profits on sales down only to the gross margin line, rather than down to a “bottom-line” product profit figure? (More generally, discuss the issues associated with incentives placed on sales, gross margins, and net profits.)
3. What modifications would you make to the proposed new plan, if any? Formulate specific recommendations.
4. Would you make any changes to the system providing bonuses to sales assistants? Which?

Student Report

Current Situation

Houston Fearless 76 (HF76) manufactures and sells products for several different markets, including photo processing, micrographics and motion picture processing, scanner products, and most recently, pollution control systems. The company has products in varying stages of the life cycle. M.S. Lee intends to increase sales and profitability in each market through strategies based on its corresponding life cycle stage.

HF76 is currently experiencing several problems. Sales of its products have slowed. Although this trend is in part due to market conditions, M.S. Lee believes the company is “not doing enough to develop new markets, to expand [its] existing markets, or to develop synergies among [its] markets.” In addition, the company’s managers believe that HF76’s performance is “lacking behind that of its major competitors on all dimensions.” HF76 is also encountering production-planning problems, which are linked to problems in forecast accuracy. Production planning is a critical success factor and is especially important due to the high cost and low volume of its products. Due to poor forecasting, HF76 is often forced to go to a semi-JIT inventory system where production is increased in response to sales orders. This has two negative side effects. First is the increase in cost to HF76. Manufacturing is forced to fill rush orders by way of overtime labor hours, thus increasing the cost of labor, which has the eventual effect of increasing cost of goods sold. The second side effect is that regardless of how fast HF76’s manufacturing division is able to produce, it is often too slow for the sales force. This has the potential to lead to unsatisfied customers and lost sales.

M.S. Lee believes that many of the company’s troubles are related to the present sales force incentive system. This system provides a base salary of \$40,000 to \$60,000 and a commission as a percentage of sales on products shipped within a salesperson’s assigned territory. The commission percentage differed across salespersons according to product characteristics, market situations, and other factors such as length of time with the company. HF76 sells products that have widely varying gross margins, some of which are even negative. The current compensation structure encourages sales, but not necessarily sales of the most profitable products. Further, because commissions are paid starting with the first dollar of sales there is no direct motivation to reach a particular sales target figure, and there is no incentive to formulate accurate sales forecasts.

Proposed Incentive Plan

HF76’s new incentive plan is an attempt to realign the sales force’s goals to address problems that HF76 is encountering. M.S. Lee had previously communicated to the sales force, which products were the most profitable; however, this “communication” has had no impact on behavior. The new system is designed to translate that message into financial terms. In an effort to stimulate profits, rather than simply revenue growth, the new system will pay commissions as a percentage of gross margins instead of sales. Additionally, M.S. Lee has made it a priority under the new compensation scheme to improve his sales force’s forecasts. He has attempted this in two ways. The first method is by setting the 70% forecast “floor.” By not paying commissions until 70% of forecast is met, he intends to discourage overly optimistic forecasts. The second method is through the 5% of base salary bonus paid for annual sales within the 10% corridor of forecast. If a salesperson falls short of 90%, or sells over 110% of forecast, he or she will lose the 5% bonus. The final component of the new incentive plan involves MBO targets, which are negotiated and subjective measures of performance upon which an additional 5% of base salary would be awarded.

The proposed system presents several problems. The change from commissions based on sales to commissions based on gross margins has several inconsistencies. First, the percentage of gross margin paid ranges from 10–12% on high margin sales to 30–35% on low margin sales. This range in percentage paid seems to negate the effect it is supposed to create. In order to induce salespeople to sell higher margin products, the rate paid on those margins should be constant. On the other hand, if the plan is structured in this way out of fairness, in that different salespersons only have access to products within a narrow gross margin percentage (some low, some high), then the plan to encourage high margin sales does not make sense. In that case, it would be beyond a salesperson's control to pursue high margin sales over lower margins. From the information available, it appears that the latter is closer to the truth. We assume that there is some margin variation within particular divisions and product lines, but that the variation across divisions and product lines is greater. Therefore, to promote higher margin sales, the percentage paid should be constant within a division and for any one salesperson. However, in the interest of fairness and equity, the percentage should vary across divisions and salespeople.

The system also does not solve the forecasting problem. The 70% floor now encourages sandbagging as opposed to optimistic forecasting. The increase in commission rate paid beyond 100% has the same effect. It seems that while there is some disincentive over the sale of the marginal unit that pushes a salesman over the 110% threshold, that disincentive is more than compensated for by the increase in commission rate paid for sales in that range. The plan will induce salespersons to provide artificially low forecasts, and their subsequent compensation will be well beyond what was intended. Absent a more effective forecasting approach, this new compensation system will not be effective in alleviating the forecasting problems of the past.

There are also problems with MBO targets. The advantages to these targets are that they can be tailor-made by M.S. Lee to address specific concerns that he has about his sales force. The major impediment is the lack of "communicability" of the MBO targets. Salespeople often prefer clearly defined compensation plans; incentives such as the percentage of sales are easy to understand.

One advantage that HF76 has for using the MBO goals is that it is a relatively small company with a family atmosphere. In this setting, M.S. Lee has the opportunity to tailor the goals to each individual.

An important problem in the forecasting area that M.S. Lee has not addressed is the difficulty of providing an accurate forecast. All of the salespeople complain that forecasting is extremely difficult, given the low volume of sales, and the abnormally long sales leads required to close a sale (often exceeding one year).

Sales vs. Gross Margins vs. Net Profits

The new compensation plan pays commissions on gross margins instead of net profits or sales. This results in salespeople being measured by sales and also production cost. Many organizations measure salespeople performance as revenue centers and measure performance based on sales. Sales personnel are responsible for making the sales and not for production. However, HF76 is different since it is selling low volume and expensive capital equipment. Production is often tailored to a specific sale that a sales person makes. Therefore, it is important for salespeople to consider production issues when making a sale.

Management does not want salespeople to be making sales that result in little or no profits. Measuring performance on gross margin forces salespeople to consider the cost of the

good sold. Salespeople will focus on quality sales that produce a profit for the company. Gross margin measures require a good communication flow between sales and production so that production schedules will be efficient. However, it is important that production managers are held accountable for production costs (i.e., by making them cost center managers). The production managers need incentives to keep cost low since they directly control these cost. This will also help the compensation of the salespeople.

However, it would not be appropriate for HF76 to include the *total*, and perhaps *actual* (as opposed to *standard*), expenses in the performance measure of the salespeople. Overhead and other expenses are out of the control of the salespeople. Unlike cost of production, these expenses are affected little by the sale of a product. Many of these costs are capital expenditure-related or other fixed costs. Measuring a salesperson's performance based on net profits would result in an inaccurate measure of their actual performance.

Recommendations

Based on the above discussion of the HF76 proposed compensation plan, we recommend that changes be made to the plan in order to improve its effectiveness. The following paragraphs discuss the changes that should help the compensation plan align the objectives of the company with the actions of the employees. However, we recognize that these changes do not provide a panacea to solving all compensation plan problems.

As mentioned, the proposed new plan does not jive with management's objective to increase sales of high margin products. These margin percentages should be adjusted as previously described. This does not, however, solve the issue of how to deal with low or negative margin products. These products are important not for the profits they generate today but the potential profits from high margin services provided in the future. Certain products are sold because the maintenance, service, and replacement parts provide high returns that negate any losses made on the original sale. The compensation plan provides no incentives for employees to sell these products. The objectives of the low or negative margin products business are different from the rest of the business and cannot be integrated into the same compensation scheme without changes to the basis on which compensation is awarded for these products. For these products, commissions should be based not on the margins of the equipment sales but on the percentage of the expected margins for the future replacement parts. Presumably, the company has already forecasted this information in its product pricing process.

We have also determined that the 5% bonus is not significant enough to be effective in encouraging accurate sales forecasting. However, we do not recommend an increase in such a bonus as we disagree with it in principle. Since management wants accurate sales forecast but does not want to deter sales growth, the forecast-accuracy bonus should be eliminated. We do not recommend a direct penalty (loss of bonus) for sales beyond a target measure. Such a penalty would act as a disincentive to increase sales beyond that measure. The payout structure should integrate the incentive for meeting forecast instead of a separate bonus plan for meeting forecast. The proposed compensation plan should be modified so that the kink is less steep beyond 100% of the forecast. In other words, the commissions as a percentage of gross margins will be lower on each sale after the 100% annual forecast. In addition, the commissions will still not be paid until 70% of the forecast is achieved; however, the amount paid at that point will reflect the percentage of total gross margin dollars up to that point and will increase at the same percentage per unit up to the 100% mark (see Exhibit 1 for graphical illustration).

Because the highest percentage will be paid within the 70–100% range, but will be paid based on total dollars, the structure provides salespeople an incentive to be more “honest” in

their forecasts. Although this structure cannot completely prevent forecasting problems and sandbagging, it does not reward them. In addition, even though the decrease in payout percentage beyond the 100% mark may encourage myopic behavior, such as sales postponement, it will do so to a lesser degree than would a flat “cap” on commissions. This structure is our best compromise for balancing goals that are sometimes in conflict.

We also recommend that management become more involved in the forecasting process. In general, forecasting, (which provides the basis for budgeting) should remain a bottom-up process. The salespeople should be required to fully explain and document their forecasts. They should also be expected to explain any differences (or lack of differences) from historical forecasts. The 100% of gross margin should represent a stretch goal (i.e., it is difficult but not impossible to meet), while the 70% is a “minimum performance standard.” Setting the two goals will allow the compensation plan to motivate employees while rewarding those who truly perform well during a period.

For compensation purposes, the annual sales forecasts should not be updated during the period, even though they should be updated for production planning purposes. The static nature of the annual targets will encourage commitment to the target and will provoke salespersons to aggressively pursue new customers and new markets when existing conditions are not according to plan.

Our recommended plan should still pay out, on average, a higher salary to salespeople to encourage buy-in. The percentages should be adjusted to reflect this financial effect. We also recommend eliminating payments to salespeople made on shipments to their regions. The payments should be made to the salesperson that made the sale.

Sales Assistants

The final aspect of the new compensation plan that needs to be modified is the bonuses for sales assistants. Sales assistants provide administrative support for the salespeople. Although they provide value to the company, sales assistants are not directly responsible for sales, gross margins, or even corporate performance. There is no link between the bonus and the performance of sales assistant. The case provides an example of a sales assistant, Eva Colton, who received a bonus. She neither expected nor understood why she received the bonus. This bonus plan provides little incentive or motivation for sales assistants to improve their performance. It should be replaced by a bonus plan that rewards assistants for accomplishing goals that they can be held accountable for. The bonus should be based on efficiency of their administrative skills like typing, computer skills, and other sales support activities. Managers should measure these skills (some perhaps just subjectively) and reward based on sales assistants performance in these areas.

Merchant and Van der Stede, *Management Control Systems: Performance Measurement, Evaluation, and Incentives*, 4e, Instructor's Manual

Exhibit 1
Recommended Compensation Structure

