UNIVERSITY OF CALIFORNIA, DAVIS
GRADUATE SCHOOL OF MANAGEMENT

271: Incentives and Controls

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Required Reading

Recommended Additional Resources
Young and O’ Byrne, EVA and Value-based Management, McGraw-Hill.


Course objective

To understand how organizations use financial and non-financial performance measurement and incentive systems to motivate people and manage resources.

Issues discussed

Fundamental questions that we address:

A. What behavior do the organization’s managers want to motivate?
B. What behavior does the organization’s incentive and control system actually motivate?
C. How do we get from B to A?

The course is designed for those who plan to be managers, management consultants, compensation consultants, financial specialists, or human resource specialists. The course uses the case method of instruction. The cases permit us to understand how management controls differ across a broad range of settings (e.g., large and small firms, manufacturing and service firms, multinational firms, start-ups). Also, cases enable us to examine the effect of context on management controls. For example, do particular types of controls work better in R&D organizations or in nonprofits or in poor performing companies that have recently been acquired. Cases help us to understand how context is critical to the shaping of management control systems.

Cases and the case method frustrate some people because, as in the real world, there is no “right answer”. At this stage of your studies, you have developed a good background in the basic language and concepts of business. This course, and similar courses in the MBA program, help you apply that knowledge. These courses also help you bridge the gap from theory and basic concepts to the real world. (“Ideas into action.”)
Grading

- Participation in class discussion (15%) and written assignments (15%). You get one free pass on attendance at a class and two free passes on written cases (or one free pass on the EVA assignment). You may discuss written assignments in advance of class—in fact, I think this is a good way to uncover issues in the case that you might not have considered on your own. Your written work must be entirely your own, however. No joint written work is allowed. Here is how this could work. You and two colleagues read a case on your own. Then the three of you meet to discuss the case, including how each would answer the assigned questions. Then, independently, each of you writes your separate case analysis.

- (50%) In class examination (open book and open notes).

- (20%) Course project or take-home case study. You may do either the take home case study, or a project on incentives and controls in an actual company. The take-home case study must be done on an individual basis without collaboration. The project may be a collaboration of two or three people. If the course project has parts that were in a project done for another class, then you must consult with both the instructor of that class and me to be assured that the scope of the paper is sufficient to justify credit for both classes. Course projects should include a discussion of the rationale for the incentives and controls, the three elements of organizational architecture, and your evaluation of the organization’s incentives and controls.

Because this is a case class, I want you contributing to class and focused on the other people who are contributing to the class discussion. Therefore, no laptops or cell phones are allowed in class. Use of laptops or cell phones in class will result in no credit for class contribution for that day’s class.
Incentives and Controls: Topic Outline

A. The general management control problem: How to design an incentive and control system to motivate people to achieve organizational goals.
   1. Agency problems.
   2. Organizational architecture
      a. Organizational structure
      b. Performance measurement
      c. Rewards and penalties

B. Organizational structure and delegation of decision rights.
   1. Hierarchy (bureaucracy)
   2. Market
   3. Culture (informal controls)

C. Performance measurement.
   1. Conventional financial measures.
      a. Project decision evaluation with DCF vs. period performance measures with accounting measures
      b. Strengths and weaknesses of conventional measures
   2. Economic value added.
      a. Nonfinancial measures
      b. Lead and lag indicators of performance
      c. Tie to strategy

D. Rewards and penalties
   1. Alternative reward methods
   2. Management incentives

E. Ethics issues, lessons from the real world

F. The effect of alternative organizations and situations on management control systems: nonprofit and multinational organizations, alternative organizational strategies, various uncertainties.
Incentives and Controls: Weekly Schedule and Assignments

Session 1 (April 1). Introduction to the course; organizational structure.

Topics:
The general problem: How to design an incentive and control system to motivate people to achieve organizational goals.

- Agency problems.
- Organizational architecture
  - Organizational structure
  - Performance measurement
  - Rewards and penalties
- Organizational structure and delegation of decision rights.
  - Hierarchy (bureaucracy)
  - Market
  - Culture (informal controls)

Homework Assignments:
Read MCS, Ch. 1 and 2.
Session 2 (April 8). Control methods

Topics:
There are four basic types of controls that we can use. We investigate circumstances in which each of these works best. The four types are:
- Results
- Action
- Personnel
- Cultural

Homework Assignments:
Read MCS, Ch. 3 and 4

Write up Houston Fearless 76, Inc. (p. 68) and Bellagio Casino (p. 153). Answer the following questions:

Houston: What are the four main business units? What are the key differences between the existing and proposed incentive plans? What is “wrong” with the existing plan? How will the new plan fix these problems? Why are “results” controls (instead of action controls) necessary? Will the proposed plan fit all four of the main business units? Why not measure and provide rewards for a bottom line profit number instead of gross margin? How do you predict that sales people will react to the plan?

Bellagio: Prepare a list of the controls that are discussed in the case. What type of control is each (i.e., results, action)? Rank the controls in terms of how “tight” they are, from very tight to very loose. (A tight control allows no room for error (e.g., how much cash is in an imprest cash fund). A loose control allows room for error (e.g., measure of an executive’s performance).) Are the controls over cash (which are internal controls) sufficient to assure good profit performance? Are the controls in place at Bellagio useful in other industries? Give examples.
Session 3 (April 15).  Control systems

Topics:
This session looks at the design of management control systems, including the costs and benefits of alternative systems.

Homework Assignments:
Read MCS, Ch. 5 and 6

Write up AirTex Aviation (p. 240) and Puente Hills Toyota (p. 253).  Answer the following questions:

AirTex Aviation: How well is AirTex performing?  (See Exhibit 2.)  Does AirTex need a new control system?  Would you have given responsibility for cash and credit to Will Leonard and Roy Douglas?  What are the implications of the flight school going to a competitor for maintenance?  Do you agree with the company’s method of allocating costs?  Was decentralization necessary?  Was decentralization a sham?  Do Ted and Frank know what they are doing?  What do you predict will become of AirTex?

Puente Hills Toyota: The case states: “Each of PHT’s departments was managed as a profit center” (near bottom of left column on p. 254).  What costs and revenues were used to measure profits for new, used and service departments?  Were inter-department transactions valued at cost or market or some other amount?  Managerial performance measurement is focused on profits at PHT.  Is profit a good measure of value creation in the car retailing business?  If so, why?  If not, what else would you use to measure the managers’ performance?  Which, if any, of the performance measures can be “gamed”?
Session 4 (April 22). Responsibility centers, budgeting.

Topics: In this session we consider issues that arise when we establish financial responsibility centers, such as transfer pricing, and the use of alternatives to ubiquitous budgeting systems. We introduce the balanced scorecard as an alternative method to the budget for performance evaluation.

Homework Assignments:
Read MCS, Ch. 7 and 8

Write up Global Investors (p. 306) and Borealis (p. 367). Answer the following questions:

Global Investors: Does the company currently use a profit center model? Cost center model? Or something else? See Exhibit 5. Is each responsibility center earning a profit? Are the profits in each tax jurisdiction generated by ‘arms-length’ transactions? Is the London subsidiary earning more profits than appears in Exhibit 5? What are the advantages and disadvantages of the current transfer pricing system? How are bonuses determined? Are transfer prices important in determining bonuses? What were the characteristics of each of the following proposed transfer pricing plans: Hoskins’ first proposal? Davis’ first proposal? Hoskins’ second proposal? Davis’ second proposal? What other suggestions do you have for the transfer pricing plan?

Borealis: Why do organizations have budgets? Why did Borealis’ management decide to abandon budgets? What are the management tools that Borealis’ management used to replace budgeting? What are the strengths and weaknesses of each of these “new” management tools?
Session 5. (April 29). Incentive compensation

Topics: Organizational architecture has three parts—(1) organizational structure and delegation of decision rights, (2) performance measures and evaluation, and (3) incentive compensation. So far, this course has focused on (1) and (2). In this session we look at alternative methods of motivating performance using incentive compensation plans.

Homework Assignments:
Read MCS Ch. 9

Write up Superconductor Technologies, Inc. (p. 411) Answer the following questions:
Superconductor Technologies: What are the components of the management compensation system for STI’s top 30 people? How are the compensation levels determined for them? Suppose you are an STI employee who is granted 1,000 shares of stock options. Without doing a numerical computation, what is your best guess about the economic value of this grant? How would the prospects of receiving or not receiving a stock option grant affect your behavior? Is STI using the right mix of incentives? Why not pay all salary or all performance dependent compensation? Are the 12 measures in the performance scorecard the right measures? What are the advantages and disadvantages of subjectively determined vs. formula based bonus plans?
Session 6. (May 6). Financial performance measures

Topics: We examine limitations of alternative financial performance measures, including conventional ROI and EVA measures. We also examine the important conflict between discounted cash flow analysis and performance evaluation.

Homework Assignments:
(1) Read MCS Ch. 10

(2) Write up Diversified Electronics (handout) Answer the questions at the end of the case. Note for the DCF analysis. If you assume the initial outflow for assets occurs at the end of time 0 and that the numbers before inflation in the case are for Year 1, then you should get an answer within five percent of $512,000 for the NPV. Be careful that you do not double count the depreciation tax shield. (I shall grade the DCF analysis for accuracy.)

(3) For a company indicated below, prepare an EVA for two recent years. State your assumptions in your write up. You will need to compute the company’s WACC. Be sure to state the companies’ Beta, the market risk premium, the risk free rate, the cost of debt and anything else that you require to compute the cost of capital. This exercise counts twice as much as a case study write up.

Here is the assignment.
If your last name begins with the letter, then your company is:
A-D.................................American Airlines
E-K...............................Continental Airlines
L-O...............................Delta Airlines
P-S.................................Southwest Airlines
T-Z...............................United Airlines
Session 7. (May 13) Managing risk

Topics: In some companies, we face the problem that managers are too short-term oriented; they don’t think beyond the current quarter’s financial results (e.g., U.S. auto industry). In many cases, managers don’t predict unexpected adverse events (e.g., U.S. airlines and terrorist attacks). Thinking beyond the current period and developing what-if scenarios is all part of managing risk.

Homework Assignments:
Read MCS Ch. 11 and 12.

Write up Southern California Edison (p. 563). Answer the following questions: What special compensation decisions did the SCE board and managers make in response to the California Energy Crisis in 2000 and 2001? Were those the right decisions? What was the board and managers trying to achieve with those decisions? Do you agree with the quote by Doug Heller on p. 568 (near top, left column)? In general, how well should you compensate managers who are facing a significant downturn in business? In general, is it appropriate to reward managers when the company is lucky but not penalize them when it is unlucky (e.g., stock options)? Should SCE’s managers have been able to foresee the California Energy Crisis and take actions to mitigate the risk? In general, how much should employees and managers be held accountable for those things that they cannot control? What incentives did the board and top management provide to turn the company around?
Session 8. (May 20)

Topics: In this session, we broaden our perspective to incorporate legal and ethical issues. We have a guest speaker, Lee Altschuler, esq. Lee is an attorney who has extensive experience prosecuting and defending white collar criminals and those accused of being criminals.

Homework Assignments:
Read MCS, Ch. 14 and 15.
Write up Lernout and Hauspie Speech Products (p. 714). Answer the following questions: Do you believe the claim by KPMG that its auditors were fooled by L&H’s management? What red flags might have tipped off the auditors, analysts and reporters? The fraud was uncovered by reporters of the Wall Street Journal. What does this say about auditors and financial analysts? Is there anything unique about this company that made it prone to fraud? For each of the following, indicate whether it was acceptable business practice, illegal (as best you can) and/or unethical, but legal: (1) Factoring unpaid accounts receivable to obtain cash upfront, with “side letters” to banks; (2) making sales at the end of the quarter that are subsequently canceled because the customers did not have the means to pay.
Session 9. (May 27)

Topics: In this session, we broaden our perspective to look at different situations that affect the design of management control systems. These include national culture, environmental uncertainty, and organizational strategy. Also, we see how the design of control systems differs in nonprofit organizations.

Homework Assignments:
Read MCS, Ch. 16 and 17.

Write up Boston Lyric Opera (p. 792). Answer the following questions: What are the advantages and disadvantages of running BLO as a nonprofit instead of as a for-profit corporation? What are the key success factors for an opera company? How different would you run the BLO if it was aimed at (1) relatively well-off, older opera lovers versus (2) young, even teenage, people who might become opera lovers versus (3) middle class people for who the opera competes with sports events and movies? In for-profit companies, the financial perspective is at the top (the ultimate objective), why is it at the bottom in Exhibit 5? What problems led to the development and use of the balanced scorecard at BLO? Recognizing that the case writer has an interest in the success of the balanced scorecard, how well do you think it will succeed at BLO?

Session 10. (June 3) In class examination
Open book and open notes.

Session 11. (June 10) Take home exams and projects due at the end of the normal class time. You may e mail these to me. mwmaher@ucdavis.edu