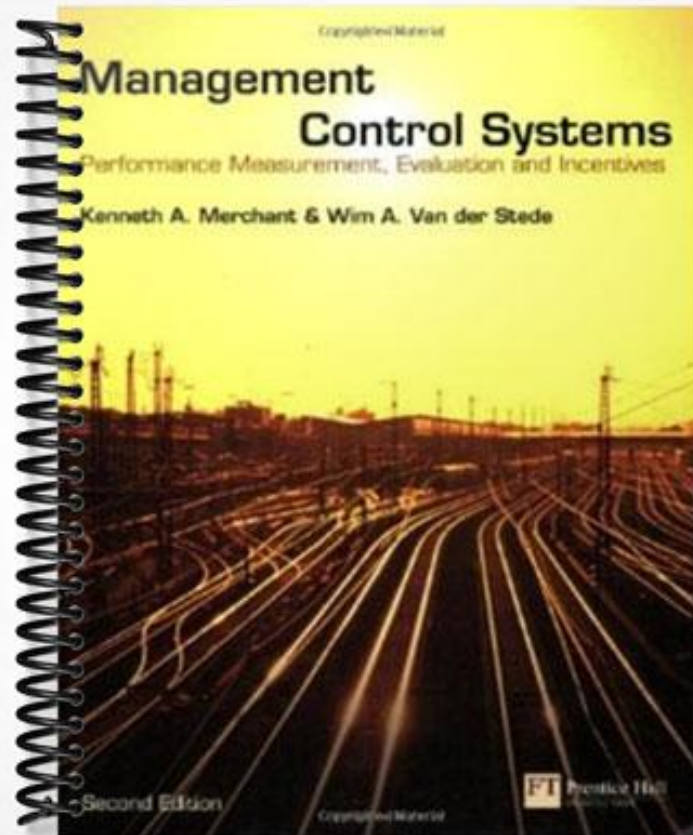


SOLUTIONS MANUAL



Instructor's Manual

Management Control Systems

Third Edition

Kenneth A. Merchant
Wim A. Van der Stede

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For instructors

- A complete, downloadable Instructor's Manual
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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 (for example, 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 71 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.

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, quite uncomfortable. 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 one “template” approach. Management control is a complex, multidimensional 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.

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 new 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 people in key positions, and the company’s history (e.g., a recent merger), some of which are dealt with in Chapter 16 (The Influences of Environmental Uncertainty, Organizational Strategy, and Multinationality on Management Control Systems). All told, the case can not only 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.

Similarly, take the Toyota Motor Sales case which we included in Chapter 7 (Financial Responsibility Centers) because it illustrates a possible change from a revenue center structure to a profit center structure. However, this case can also be used effectively in Chapter 10 (Financial Performance Measures and Their Effects) because an important concern in the case is whether a focus on accounting profits will make the new profit center managers (regional general managers) excessively short-term oriented (myopic); in Chapter 12 (Using Financial

Results Controls in the Presence of Uncontrollable Factors) because controllability is a critical issue that must be considered in deciding whether to give the regional general managers profit responsibility; or in Chapter 16 because it illustrates how external forces, in this case changes in the competitive environment, affect business strategies and, in turn, MCSs.

To give yet another example, the Catalytic Solutions case, which is included in Chapter 11 (Remedies to the Myopia Problem) to illustrate the use of nonfinancial performance measures, also can be effectively used in Chapter 2 (Results Controls), Chapter 6 (Designing and Evaluating MCSs), and Chapter 9 (Incentive 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). The case can also be used in Chapter 16 because of the critical importance in this start-up company of meticulously executing strategy and dealing with the high uncertainty and risk in the environment.

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 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 (one lecture and one seminar) per week. 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, and so on, 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 transparencies for each chapter of the book developed by Wim A. Van der Stede, as well as databases (Excel spreadsheets) for the Bank of the Desert (A) and (B) and the VisuSon, Inc. case studies.

June 2011

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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	T/Th 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 (2012), <i>Management Control Systems: Performance Measurement, Evaluation and Incentives</i> . London: Financial Times/Prentice-Hall, 3 rd 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. And 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 on the basis of 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. And 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, 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

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 4

Topic: Performance Targets

Annual financial performance targets are an important outcome of companies' planning and budgeting processes. How challenging should these targets be, and how should achievement of the targets be linked to various forms of rewards, such as incentive compensation and job retention?

Reading: MV, Chapter 8

Prepare for Class: Case: HCC Industries

Assignment Questions:

1. Evaluate the decision to use "minimum performance standard" (MPS) targets instead of "stretch" targets.
2. Should HCC managers have expected that the MPS target-setting philosophy would be equally effective in all four operating divisions described? If not, what explains the differences?
3. What should Andy Goldfarb do now?

E-mail Question:

Mike Pelta, general manager of Hermetic Seal, is quoted in the case as saying he has not missed a budget in his 33 years as a manager. How do you think he did that? Does this record suggest

that Mike is an extremely effective manager, a very lucky manager, or a devious, manipulative manager? Is he to be congratulated for his budget-achievement record?

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.

Reading: MV, Chapter 13

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 of 2002

In this session, we will focus on the benefits and costs the Sarbanes–Oxley Act of 2002 (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 2 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: Was Don Russell a good controller for Cook and Spector, Inc.? Why or why not?

Session 10

Topic: Financial Reporting Problems and Corporate Governance

In this class, we will focus on the roles of various parties when financial reporting problems are discovered.

Reading: MV, Chapter 15

Prepare for Class: Case: Financial Reporting Problems at Molex, Inc.

Assignment Questions:

1. What was the financial reporting problem at Molex? How would the correction of the problem be recorded in Molex's financial statements?
2. What factors do you think influenced management's decision not to raise the issue with the auditors?
3. Why were Molex's auditors so concerned about the reporting problem at Molex? If you were a member of the board, would you agree with their concerns?
4. As a member of Molex's board, what would you do to respond to the auditor's request that the CFO (and possibly the CEO) be replaced?

E-mail Question: If Molex changes auditors, would you expect that event to have a significant negative effect on the stock price? If so, why? If not, why not?

Session 11

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.

Reading: MV, Chapter 2

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 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, Chapter 10

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.

Reading: MV, Chapter 9

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

The London School of Economics and Political Science

Department of Accounting

AC310

Advanced Managerial Accounting

Module 2

Michaelmas Term (Weeks 6–10)

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 2 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 (2012), *Management Control Systems: Performance Measurement, Evaluation, and Incentives* (Prentice-Hall/Financial Times), 3rd 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 lecture/class 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 three-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: *The Lincoln Electric Company [in Chapter 4; not Chapter 16]*

Case Questions (for advance preparation):

1. How would you describe Lincoln's approach to the organization and motivation of their employees?
2. What role do you think this approach has played in Lincoln's performance over the last 25 years? Have any other factors been more important?
3. What factors will be critical for Lincoln's future success?
4. What recommendations would you make to Mr. Willis?

Essay Question (for written work):

Despite their outstanding success domestically, Lincoln's internationalization thrust of the late 1980s and early 1990s failed. Is Lincoln's approach to the organization and motivation of employees "exportable" outside the US? What are potential barriers to adopting the Lincoln approach abroad?

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, 95-116.

Case: *Citibank Indonesia*

Case Questions (for advance preparation):

1. Analyze the budgeting process at Citibank and how the budget is used for performance evaluation of managers.
2. Are managers at Citibank committed to achieving budget targets? If so, are the budget targets too challenging? Is there any evidence of budget gaming?

Essay Question (for written work):

What should Mr. Mehli Mistri do about the budget issue described on the first page of the case study?

Class 3: Two Budget Targets

MCS, Chapter 15; and,

Jensen, Michael (2001), Corporate Budgeting is Broken, Let's Fix it, *Harvard Business Review*, November, pp. 95–101.

Case Question (for advance preparation),

or **Essay Question** (for written work):

Are Joe's actions ethical or unethical? Explain.

Week 4 – Performance Measurement

Lecture 4: MCS Chapters 10–12; and,

Kaplan Robert S. & David Norton (1992), The Balanced Scorecard: Measures that Drive Performance, *Harvard Business Review*, January–February, pp. 71–79.

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	T/Th 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 (2012), <i>Management Control Systems: Performance Measurement, Evaluation and Incentives</i> . London: Financial Times/Prentice-Hall, 3 rd 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 (2012), *Management Control Systems* (London: Financial Times/Prentice-Hall), 3rd 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

Quizzes	50 points
Project 1	50 points
Project 2	50 points
Class participation	50 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 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 evaluating 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 and 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 on the basis of 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, 2, 3, 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 1

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 result, 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

Two young and inexperienced MBA graduates purchase a small aviation company that is in financial trouble. They have to make a number of control-related judgments and possibly implement a new control system quickly.

Reading: MV, Chapter 6

Prepare for Class: Case: AirTex Aviation

Assignment Questions:

1. Did AirTex need a new control system at the time of the takeover?
2. Evaluate the control system that Frank and Ted implemented. Should anything have been done differently?

E-mail Question:

A short time after Ted and Frank took over AirTex, one of the employees on the fuel line went to Ted and asked if he could grow a beard. Under the former administration, they had been prohibited. Ted said, "Yes, as long as you keep it neat." Was that a good answer to this question? Is this question relevant to a class focused on control systems?

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'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 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. Fettinger do?

E-mail Question: Is a transfer price just a cost allocation with a profit margin tacked onto it? Explain.

Session 6

Topic: Budgeting and the Setting of Financial Performance Targets

Planning and budgeting processes are important, and often complex, elements of companies' management control systems. Here we will examine a somewhat typical company process and focus particularly on the issue of how challenging annual budget targets should be.

Reading: MV, Chapters 8 and 9

Prepare for Class: Case: HCC Industries, Inc.

Assignment Questions:

1. Draw a diagram of HCC's budget process. Make the x-axis the months of the year. Make the y-axis the levels in the HCC organization. Who does what when?
2. Evaluate the decision to use "minimum performance standard" (MPS) targets instead of "stretch" targets.
3. Should HCC managers have expected that the MPS target-setting philosophy would be equally effective in all four operating divisions described? If not, what explains the differences?
4. What should Andy Goldfarb do now?

E-mail Question:

Mike Pelta, general manager of Hermetic Seal, is quoted in the case as saying he has not missed a budget in his 33 years as a manager. How do you think he did that? Does this record suggest that Mike is an extremely effective manager, a very lucky manager, or a devious, manipulative manager? Is he to be congratulated for his budget-achievement record?

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: The Planning Role of Budgets: Business Stress Testing

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 #1. The assignment is posted on Blackboard. We will hear some of the presentations and will discuss the case in the next class.

Session 8

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 9

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, Chapters 2 and 16

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 10

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 US 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 US 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 US 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 11

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”.

Reading: MV, Chapter 10

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 12

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

Today's discussion focuses on a company that places primary control emphasis on *nonfinancial* measures of performance. Why do they do that?

Reading: MV, Chapter 11

Prepare for Class: Case: Catalytic Solutions, Inc.

Assignment Questions: 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 systems to be different at that time? If not, why not? If so, how and why?

Session 13

Topic: Combinations of Measures: KPIs, Dashboards, and Balanced Scorecards (cont.)

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.

Reading: Particularly if you are interested in management of not-for-profit organizations, read MV Chapter 17. That topic will be a secondary focus of this class session.

Prepare for Class: Case: Boston Lyric Opera

Assignment Questions:

1. The Boston Lyric Opera (BLO) working group selected eight customer objectives for its three strategic themes (described in the case and summarized in the Customer row of Exhibit 5 of the case):
 - a. Develop loyal and generous supporters
 - b. Build reputation on the national and international opera scene
 - c. Reach the Boston-area community

What **measures** should the project team select for these eight objectives?

2. What changes were required to adapt the Balanced Scorecard to a nonprofit organization?
3. What are the benefits from developing the Balanced Scorecard at BLO? What challenges and barriers must Del Sesto and Dahling Sullivan overcome to capture these benefits?
4. Are the departmental managers, artistic leaders, and employees at the BLO more empowered or less empowered after the Balanced Scorecard has been created?
5. Is Janice Del Sesto using the Balanced Scorecard as a performance measurement system or a management system?
6. What was critical for success in the process used to develop the Balanced Scorecard?

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 14

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 15

Class cancelled to allow time to work on group project #2 on performance evaluations.

Session 16

Topic: Performance Evaluations: Group Project #2

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 17

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 18

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 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: Was Don Russell a good controller for Cook and Spector, Inc.? Why or why not?

Session 19

Topic: Control Impacts of the Sarbanes–Oxley Act of 2002

In this session, we will focus on the benefits and costs to corporations of the Sarbanes–Oxley Act of 2002 (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 20

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, 2, 3

Prepare for Class: Case: Vector Aeromotive Corporation

Assignment Questions:

1. Why did Vector Aeromotive 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 Gerry Wiegert?
3. What should the board members do now (March 22, 1993)?
4. What could have prevented or minimized the problems that Vector 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 Vector Aeromotive would have occurred? Explain.

Session 21

Topic: Fiduciary Obligations Surrounding Financial Reporting

In this class, we will focus on the roles of various parties when financial reporting problems are discovered.

Prepare for Class: Case: Financial Reporting Problems at Molex, Inc.

Assignment Questions:

1. What was the financial reporting problem at Molex? How would the correction of the problem be recorded in Molex's financial statements?
2. What factors do you think influenced management's decision not to raise the issue with the auditors?
3. Why were Molex's auditors so concerned about the reporting problem at Molex? If you were a member of the board, would you agree with their concerns?
4. As a member of Molex's board, what would you do to respond to the auditor's request that the CFO (and possibly the CEO) be replaced?

E-mail Question: If Molex changes auditors, would you expect that event to have a significant negative effect on the stock price? If so, why? If not, why not?

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 recently 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. There is a case on DPC in MV. While we will not be discussing that case, skimming the early sections of that case would help you gain some perspective on the company that Michael ran.

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 Roundtable website (www.bbrt.org). Click on the “Beyond Budgeting” tab on the left panel. Read the material in that section, titled “About Beyond Budgeting.”

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 increasing high emphasis on achievement of budget goals, as they did, should HCC managers (remember our earlier class?) have gone “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 Roundtable 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.