15.963 Managerial Accounting and Control

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Return on Investment (ROI) is commonly used for divisional performance evaluation and implicitly compared to cost of capital, so that the EVA concept is implicitly used. To prevent underinvestment, the formula can be modified. E.g., Mars (the candy company) uses replacement value, rather than book value, of invested capital in the denominator.

At Vyaderm, there was one metric used to evaluate performance and determine the bonus – EVA.

Companies (e.g., Citibank) often use multiple metrics, both financial and non-financial.
These metrics are used to capture:
- Financial performance,
- customer satisfaction,
- internal business processes, and
- learning and growth.

Some advantages of this performance scorecard include:
- redistributing managerial attention toward broader value drivers;
- balancing long-term and short-term orientations;
- communicating value drivers and thereby increasing goal alignment;
  - e.g., having EVA as the sole performance measure does not tell employees how to achieve high EVA (or what its drivers are).
- and mapping a path for implementing strategy.
What is Citibank’s competitive strategy in California?
- They are niche players here. They have a relationship banking / high service strategy.
- Frits wants employees to have a broader view and long-term focus, hence the performance scorecard.

What problems do you see with the performance scorecard?
- Will managers over-invest in the easiest, rather than most value-adding, goals?
- Could some measures (e.g., learning and growth) become value-consuming rather than value-adding?
- Can multiple goals be distracting?
Does the performance scorecard specify the tradeoffs between the different goals?

- Can you maximize on more than one dimension without knowing the tradeoffs?
- i.e., what is the aggregation rule for the scores on different dimensions?
- In the end, we need a single score to judge performance, and will use an implicit aggregation rule in the absence of an explicit one.
- So it may be better to have an explicit one.

What do you think of the customer satisfaction measure?

- Is it a leading indicator of future financial performance?
- Should uncontrollable aspects of service, such as ATM’s and 24 hour phone banking be included in the survey?
- Are 25 surveys representative of the customer population for the branch?
How is McGaran’s branch different from others in L.A.?

- It has a diverse customer base.
- It is in the financial district, and so has many demanding customers.
- Competitors are less than a block away.
- It is not in a residential area, so it likely has a higher-churn customer base.
What is an important agency problem in this setting (geographically dispersed branches)?

- The free-rider problem.
- A given branch can free-ride on the brand reputation by lowering (service or product) quality.
- The branch receives the full benefit from the cost-of-quality savings, and bears only a fraction of the cost.
- This free-rider problem is accentuated by the managerial horizon problem.
  - The manager can skimp on quality and save costs, get promoted in a couple of years, and pass the cost of reduced quality on to the next manager.
The free-rider problem is more of an issue when the cost of reduced quality is revealed more slowly.

How does this relate to the customer base of the branch?

- If the customer base is low-churn, i.e., lots of repeat customers, then cost of reducing quality is very high for the branch.
  - E.g., if the branch is in a residential area. Customers are lost and word of mouth spreads.
  - Effect of low quality shows up quickly in revenues.

- If customer base is transient, i.e., lots of one-time customers, cost of reducing quality is very low for the branch.
  - Effect of low quality is unlikely to show for a few years or several years (depending on composition of customer base).
Do you think this is a problem at McGaran’s branch? Why?

- Likely. Profits exceed plan by about 19%.
  - Of course, the target may have been too low, but this is usually not the case. Area manager thinks target is aggressive (Exhibit 2).
- Perhaps not. Revenues have grown, and there is growth in all business segments.
  - But again, if the business is generally growing, and if customer base is highly transient, will the effect of poor quality show up in revenues?
Why does the area manager appear to underweight the poor customer satisfaction scores?

- Perhaps customers are rating support services, such as ATM’s, that are not controllable at the branch level.
- However, this should be the case at every branch then.

Is the answer in her performance measurement scheme?

- Most likely, though the case provides no evidence on this.
- If McGaran’s scheme does not specify the tradeoffs between the dimensions, is it likely that hers does?
- She has 31 branches, which will help dampen the effect of poor customer satisfaction scores at one branch.

To align goals, there must be congruence along the reporting chain.
What is the effect of a discrete performance scale (below-, at- or above- par)?

- Increasing the rigidity of the system induces behavioral distortions.
- A manager may manage numbers to reach a higher category,
- or abandon the goal altogether if the higher category is unreachable in a given year.
- Manager’s may be forced to break rules, which undermines those rules. E.g.,
  - why did Johnson give McGaran a “par” rating on customer satisfaction in two quarters?
  - Why is Frits faced with a dilemma whereby he might have to break the rule for giving an “above par” rating?
- There is a loss of information – comparisons across managers and over time are coarse.
Reinforcing this problem is a discrete bonus payoff scheme – 0, 15%, 30%. This can be seen as imposing high risk, and it will provide further incentive for behavioral distortions.

Does the scorecard help balance long term and short term incentives, as intended?

- The way to do this is to reward a long term orientation.

Would a bonus bank, as at Vyaderm, be useful?

- This could be used to smooth bonus payments. If beating plan by a wide margin does not pay off as much today, it might reduce divergent behavior.
- Customer satisfaction scores could be used to determine contributions to the bonus bank.
- Poor customer satisfaction scores in a single quarter will not affect the bonus payout from the bank as much.
- If gains from customer satisfaction will show up in a few years, manager is assured that these gains eventually will show up as bonus payments. McGaran can tradeoff some profit today, for much higher returns from customer satisfaction in a couple of years.
- Make the bonus bank portable, to control the horizon problem.
What would you do with McGaran now?

One solution is to override the system and give him an overall above-par, but then to limit his bonus to 20% (instead of 30%).

As an aside, what does McGaran’s “willingness to work weekends, holidays and during his vacation to ensure customer satisfaction, operational control and financial growth” tell you about him as a manager?

A manager should be able to effectively delegate, and should be able to build a system (well-developed employees and procedures, etc.) to preclude the need for this.

In emergencies however, his willingness is admirable.
How effective is McGaran’s performance scorecard?
- Customer service is vital to Citibank California’s strategy, but the scorecard is not communicating this.
- The scorecard is not aligning goals along the reporting chain.
- It does not provide long-term incentives.

How would you redesign the performance measurement system?
- Specify the weights for the different performance dimensions.
- Have a continuous performance scale and bonus payoff scheme.
- Ensure goal congruence along the reporting chain.
- Introduce a bonus bank to limit large single-period gains from well-above-plan profitability and to provide long-term incentives.