Industrial Electronics

Issues

- Management Control System is ineffective
- It does not lead to payment of bonuses, and managers are discouraged
- New bonus system is proposed

Background / Environment

IE is a high-tech company operating in many business areas; difficult to forecast future accurately
Could turn out to be harsher operating environment than expected

Recession is making it hard to meet goals

Some divisions still do well, even with recession; it is not clear whether this results from their actions, or is merely coincidental
It is possible some divisions may work very hard, but cannot control the general economic environment

STRENGTHS: Top Mangement cares about motivating & rewarding divisions
WEAKNESSES: Current bonus structure does not lead to bonus payouts
OPPORTUNITIES: What can you identify as opportunities?
THREATS: Recession

KSF's

MAXIMIZE SHAREHOLDER VALUE !

Innovation: must be innovative to stay ahead of competition
Tight control over costs (experiences significant price competition)

Current MCS

Organized by product lines
Profit Centers: 16 relatively autonomous divisions

Management bonus: 25 eligible managers: bonus based on company-wide performance
"Bonus Pool" - 10% of corp profits after tax, in excess of 12 % net worth
Bonus calculation based on "award per dollar of salary" - up to 150%

Bonuses have traditionally been 30-120 percent of salary, average 50%
NO BONUS for 2000, 2001 - bonus pool was ZERO

<u>Advantages:</u>

- Bonus structure allocates wealth; pays bonus when company is ABLE to do so
- May encourage teamwork - everyone needs to win for anyone to win
- Performance targets are fixed and do not change over time; no politics & negotiations to worry about
- System is easy to understand

<u>Disadvantages</u>

- Overall corporate performance is hard to control by any one division's efforts
  - A division with a really good or really poor performance still gets same bonus as every one else
- 12% goal does not reflect economic situation or changes in circumstances
- Profit after tax is not a good reflection of value creation
- No charge for use of assets that are financed by debt
- Bonu cutoffs where corp performance is below 12% or above 150% are both dismotivating to managers who may work hard but not be rewarded for their efforts
- In some regions, there is no apparent link between performance and bonus rewards
- Current structure may lead to "game playing" - moving income and assets between performance periods in order to manipulate bonuses

New Bonus Plan

1 Div managers' bonus based 100% on divisions performance
Group manager's bonus based 100% on group performance
Corp manager's bonus based 100% on corp performance

2 Actual performance compared to targets negotiated during annual budget process
Set budgets to be 80-90 % achievable by respective teams
Forecasts hard to predict accurately due to high-tech nature of business;
yet management wanted bonuses to be attainable

3 Economic Profit objective given to each division
(Budgeted operating profit) - (Budgeted operating assets x 12%)
12% = weighted average cost of capital
See example at bottom of page 52

4 Actual investment base - top of page 53; cash, receivables & inventory, fixed assets
(Current & Fixed Assets)

5 If actual economic profit = ojective, manager would earn bonus = 50% of salary
Bonus increases by 5% for each $100,000 above objective
Bonus decreased by 5% for each $100,000 below objective
Maximum bonus = 150% of salary

FINANCIAL ANALYSIS:

Division	Budgeted Economic Profit Objective	Actual Economic Profit	Profit Variance from Target	Bonus as Percent of Salary	
A	40	310	270	63.5%	
B	40	3,660	3,620	150.0%	Maximum Allowable
C	-70	204	274	63.7%	
D	-1,180	-804	376	68.8%	
E	360	-116	-476	26.2%	Less than 50%, because targets not met

See detailed calculations below

<u>Advantages</u>
Managers are held accountable only for the areas they control
Rewards are based on economic profit, which reflects the use of assets - not just profits
The type of financing will not affect bonus
Performance targets are tailored to each business unit; more realistic & more equitable -
would encourage more commitment from managers

<u>Disadvantages</u>
Performance measure focus on short-term results; discourages investment in assets or R&D
Particularly troublesome in a high-tech industry that relies on INNOVATION
Measures are not linked to strategy, and provide no guidance on how to meet targets
Cash is arbitrarily assigned to operating units. No explanation is given for why
Using NBV for assets means profits will go up over time due to amortization, without any
effort at all from management
No adjustment made for whether assets are owned or leased
Cost of capital seems to be fixed: does not vary with operating units & does not vary over time
Bonus is set at 50% of salary; everyone seems to get a bonus of some kind.
Less than 50% if performance is less than target; but at least something
How can the company afford to pay bonuses when there is a loss?
Seems to be little organizational interaction
Plan may be overly complex and hard for managers to understand

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Division	Budgeted Operating Profit	Budgeted Operating Assets	Actual Operating Profit	Actual Operating Assets	Economic Profit Objective	Economic Profit Objective
A	1,000	8,000	1,150	7,000	=1,000 - (8,000*.12)	40
B	1,000	8,000	4,500	7,000	=1,000 - (8,000 *.12	40
C	50	1,000	300	800	= 50 - (1,000*.12)	-70
D	-700	4,000	-300	4,200	= -700 - (4,000 * .12	-1,180
E	600	2,000	100	1,800	= 600 - (2,000*.12)	360

NOTE: (Budgeted Operating Profit) - (Budgeted Operating Assets x .12)

Actual Economic Profit	Actual Economic Profit	Profit Variance from Target	Bonus for meeting objective	Bonus for Exceeding Objective	Profit Calculation	Profit Percent	
=1,150 - (7,000 * .12)	310	270	0.50	=270*.05	= .50 + .135	63.5%	
= 4,500 - (7,000*.12)	3,660	3,620	0.50	1.00	= .50 + 1.0	150.0%	MAXIMUM ALLOWABLE
= 300 - (800*.12)	204	274	0.50	=274*.05	=.50 + .137	63.7%	
=-300 - (4,200*.12)	-804	376	0.50	=376*.05	=.50 + .188	68.8%	
=100 - (1,800*.12)	-116	-476	0.50	= - 476*.05	=.50-.238	26.2%	Less than 50%, because lower th
				=3620*.05	= .50 + 1.81	231%	
				could have earned 231% - but caps at 150%			