Aalto-yliopisto
Kauppakorkeakoulu

ISSUES IN PERFORMANCE MANAGEMENT

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AGENDA

- Remedies to the Myopia Problem
- Performance evaluation in the presence of uncontrollable factors
- Ethical issues related to MCS
- Transfer Pricing

REMEDIES TO MYOPIA PROBLEM

- Myopia = short-term orientation in decision-making
- Financial results control systems tend to produce myopic behavior
- Remedies include:
  - Reducing pressure for short term profits
  - Using pre-action reviews
  - Lengthening the horizon
  - Changing what is measured
    - Other proxies for shareholder value than accounting measures
    - Improving accounting measures
    - Using non-financial measures / drivers

Mutually Exclusive Capital Projects

NPV

	X (€)	Y (€)	Z (€)
Machine cost initial outlay (time zero)	861	861	861
Estimated net cash flow (year 1)	250	390	50
Estimated net cash flow (year 2)	370	250	50
Estimated net cash flow (year 3)	540	330	1100
Estimated NPV at 10% cost of capital	77	(52)	52
Ranking	1	3	2

Profits

	X (€)	Y (€)	Z (€)
Year 1	(37)	103	(237)
Year 2	83	(37)	(237)
Year 3	253	43	813
Total profits	299	109	339

Return on investment

	X (%)	Y(%)	Z (%)
Year 1	(4.3)	11.9	(27.5)
Year 2	14.5	(6.4)	(41.3)
Year 3	88.1	15.0	283.2
Average	32.8	6.8	71.5

REMEDIES TO MYOPIA

- Reducing pressure for short term profits
  - Reduce relative weight of profits and increase weight of e.g. non-financial aspects
  - Make targets easier to achieve - > risks?
- Control investments with pre-action reviews
  - Use margins that do not reflect investments
    - would EBITDA do the job?
  - Merchant & Van der Stede suggest distinction between operating expenses and developmental investments
  - Investments then decided based on proposals
  - Variations of this used in practice, e.g. certain development ideas funded at higher organizational levels
  - What issues this might create?

REMEDIES TO MYOPIA

- Extend the measurement horizon (+ long term incentives)
  - We discussed this already during incentives lecture
  - Remember “mental discounting”
  - If these are accounting based, may create similar sandbagging to budgeting
- Change what is measured
  - M&VdS discuss estimating future cash flows at the beginning and at the end of period -> why not commonly used in practice?
  - Improve accounting measures (change how costs are treated as expenses or activated to BS; imputed costs - e.g. fully depreciated assets still in use; EVA)
  - Measure value drivers (we discussed BSC and VBM already)

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EVALUATION IN THE PRESENCE OF UNCONTROLLABLE FACTORS

- People are typically risk averse -> controllability principle
- Firms that held people accountable for uncontrollable factors will bear some cost
  - Higher expected value of compensation
  - Adverse employee behaviors, e.g. not investing in R&D, game playing, etc.
  - Excuses -> lost time + tension
  - Lost motivation, sense of unfairness
- Basic economic argument: owners should bear the risks, not employees

EVALUATION IN THE PRESENCE OF UNCONTROLLABLE FACTORS

- Different types of uncontrollable factors
  - Economic and competitive factors
  - Force majeure
  - Interdependencies (within firm)
    - Pooled (different units rely on common resources)
    - Sequential (outputs of one unit are inputs for another)
    - Reciprocal (bi-directional sequential interdependencies)
    - Interventions from above
- Should these all be treated in similar fashion in performance evaluation?

EVALUATION IN THE PRESENCE OF UNCONTROLLABLE FACTORS

- Two approaches to deal with uncontrollable factors:
  - Before the measurement period
    - Insurance
    - Responsibility structures, i.e. hold employees accountable for the performance areas that management wants them to pay attention to -> design and use of financial performance measures
  - After the measurement period
    - Variance analysis
    - Flexible performance standards, such as use of flexible budgets
      - Budgets are modified to reflect actual conditions, not used often in practice
      - Scenario / what-if plans
      - Updating standards more frequently

EVALUATION IN THE PRESENCE OF UNCONTROLLABLE FACTORS

- After the measurement period
  - Relative performance evaluations (internal or external)
    - For what type of organizations this works well?
  - Subjective performance evaluations
    - Measures / indicators can not capture all important aspects
    - What are the potential problems of subjective evaluations?

- Should uncontrollable factors be treated in similar fashion for all purposes evaluations are used?
- Evaluators adjust uncontrollable factors normally only in favor to employees – they protect them from bad luck, but do not protect shareholders from good luck

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ETHICAL ISSUES RELATED TO MCS

- Managers have to control for unethical behaviors within organizations
- Some of pressures to behave unethically may be created by organizations performance management system
- Or, one may argue that good performance management system should encourage also for ethical behavior
- Issue: good (financial) performance and good ethics are not always the same – examples?
- Codes of professional conduct are common
- Note: unethical and illegal are not synonyms

ETHICAL MODELS

- Merchant & Van der Stede discuss four models:
  - Utilitarianism
    - “Greatest good for the greatest number of people”
    - Are the expected outcomes likely to be greater than in other alternatives? To whom?
  - Rights and duties
    - Does a decision violate some of the rights people have? Does a decision or act allow one to escape from some duties?
  - Justice / fairness
    - Treating the people same except when they are different in relevant ways
    - Outcomes do not necessarily need to be fair as long as the process is
  - Virtues
    - E.g. integrity, loyalty, courage

FRAMEWORK FOR ANALYSIS

- Framework for analyzing ethical issues
  - Clarify the facts (what, who, where, when and how)
  - Define the ethical issue
  - Specify the alternatives
  - Compare values and alternatives
  - Assess the consequences
  - Make a decision

WHY DO PEOPLE BEHAVE UNETHICALLY?

People are different:

- “Bad apples”, dishonest people
- Morally disengaged or ignorant
- Rationalizers
- Lack of moral courage

MANAGEMENT CONTROL / ACCOUNTING RELATED ISSUES

- Creating budget slack
- Managing earnings
- Responding to flawed performance indicators
- Using controls that are “too good”
- Any other examples?

‘I'm not a robot’: Amazon workers condemn unsafe, grueling conditions at warehouse

Ilya Geller, who worked as a stower, told of the pressure workers face from being surveilled by computers to ensure productivity rates are met.

“You’re being tracked by a computer the entire time you’re there. You don’t get reported or written up by managers. You get written up by an algorithm,” said Geller. “You’re keenly aware there is an algorithm keeping track of you, making sure you keep going as fast as you can, because if there is too much time lapsed between items, the computer will know this, will write you up, and you will get fired.”

The Guardian 5 Feb 2020

DIGITALIZATION AND ETHICS

- What kind of ethical issues may arise when companies adopt new digital technologies in their accounting and control systems?

sanoo indeksin tuottavan
Chris Williamson tiedotteessa. **HS**

Quuppa keräsi isot rahat tekniikalleen

SUOMALAISYHTIÖ Quuppa on saanut huomattavan rahoituksen liiketoimintansa kasvattamiseen. Vuonna 2012 perustettu yhtiö on ollut tähän mennessä perustajien ja työntekijöiden omistuksessa. Nyt se kertoo keränneensä 20 miljoonan euron kasvupääoman rahoituskierroksella, jossa keskeinen rahoittaja on pääomasijoitta- ja Bocapin hallinnoima rahasto. Quupan pääasiallisia tuotteita ovat erilaiset sisätilapaikannukseen perustuvat tekniset ratkaisut, joilla voidaan seurata esimerkiksi työntekijöiden sijoittumista sisätiloissa lähes reaaliaikaisesti. Sisätilapaikannuksella on ollut kysyntää etenkin teollisuudessa, mutta viime vuosina yhtiön asiakkaiksi on tullut myös teknologiayrityksiä ympäri maailmaa. **HS**

Matkailu: Ala ei kestä uusia rajoituksia

MATKAILUALA on ajautunut niin tukalaan tilanteeseen, etteivät

SUMMARY OF ETHICS DISCUSSION

- Employee ethics is an important component of personnel or cultural controls
- If good ethics can be encouraged, it can substitute for action or results controls
- It is important for you to be able to recognize when ethical issues arise (we discussed some typical MCS related issues) and have a framework to make a judgement in those situations

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TRANSFER PRICING

- In an international setting, questions regarding transfer pricing refer typically to tax issues
- Arm's length pricing required by OECD and local tax authorities
- There are also other problems than taxation related to transfer pricing

THE PURPOSES OF TRANSFER PRICES FROM MANAGEMENT CONTROL PERSPECTIVE:

1) To motivate divisional managers to make optimal economic decisions from the viewpoint of a whole company

2) To determine the profit/loss of a division based on which the managerial and economic performance of the division can be evaluated (objectives and allocation of resources)

3) To ensure that divisional autonomy is not undermined

Note! No single transfer price is likely to meet all of the set objectives

TRANSFER PRICING METHODS:

- Market-based transfer price
- Cost-based transfer price
- Negotiated transfer price
- Transfer price set by headquarters

MARKET PRICE

- Theoretically superior, if perfectly competitive market exists
- However:
  - market is seldom perfectly competitive → market price is appropriate, if quality, delivery, discounts and back-up services are identical to other products in the market
  - market imperfections caused by distressed companies

    → if market is not perfect, then the use of market prices may lead to incorrect decisions
  - marketing costs of supplier are not incurred

COST- BASED TRANSFER PRICE

- Marginal costs, full costs or full cost plus a mark-up
- According to economic theory, the optimal transfer price is the marginal cost of the supplying division, if market price cannot be applied
- Seldom used in practice

MARGINAL COSTS: POSSIBLE PROBLEMS

- Supplier does not receive profits and has no incentives to control overheads
- Maximum overall company profits are not guaranteed, if supplier's capacity is constrained and it is forced to sell internally
- Supplier will sell externally, if it is able to receive a higher price from external sales
- Receiving division may under-price the final products/services sold to end customers

FULL COSTS

- ADVANTAGES:
  - Supplier recovers its costs
  - Receiving division emphasize cost efficiency
  - Receiving division has a picture of supplier's full costs
- DISADVANTAGES:
  - Supplier does not make any profit
  - Supplier may refuse to sell internally, if it can add a mark-up to external sales

FULL COST PLUS A MARK-UP

- ADVANTAGES:
  - Supplier obtains profit
- DISADVANTAGES:
  - Receiving division may pay more than what the actual value of product is, if it has no right to refuse and buy outside
  - In a long supply chain, the price paid by the end customer includes excess internal mark-up -> threat to competitiveness

NEGOTIATED TRANSFER PRICES

- ADVANTAGES:
  - Often considered to be relatively fair
- DISADVANTAGES:
  - Time consuming
  - Negotiating skills decisive, may lead to decisions less than optimal from the viewpoint of a company as a whole
  - In order to work, divisions should have equal bargaining power

TRANSFER PRICES SET BY HEADQUARTERS

- E.g. market price – 10 % or full cost + 5 %
- Neither based on economic logic as market- and cost-based transfer prices, nor on responsibility logic as negotiated transfer prices
- The aim is to simplify the situation
- Sometimes, the aim might be to reach a fair distribution. E.g. if each division would have been able to acquire certain service at a certain price, but if the acquisition is centralized, the service is received at a lower price => the received benefit is shared fairly between divisions

TRANSFER PRICING IN PRACTICE

Similar results are reported all over the world:

- 35-40 % of firms use market price/adjusted market price
- 15-20 % of firms use negotiated price
- 40-50 % of firms use cost-based transfer price
- 5-10 % of firms use marginal costs as a transfer price

- There are differences in how domestic and international transfer prices are set. Domestic transfer prices are more commonly based on costs, whereas international transfer prices are market based due to more and more stringent tax regulation.

HOW TO SOLVE TRANSFER PRICING CONFLICTS IN PRACTICE?

If no capacity constraints:

a) Supplier's marginal/variable cost + a fixed lump-sum charged from the receiving division
→ benefits and disadvantages?

b) Dual-rate transfer pricing system
- supplier's marginal/variable cost is charged from the receiving division, the supplier receives marginal cost + a mark-up, in other words, two transfer prices in practice
→ benefits and disadvantages?

SUMMARY / REFLECTION – KEY LEARNINGS REGARDING OUR AGENDA?

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