15.963 Management Accounting and Control
Spring 2007

15.963 Managerial Accounting and Control

Spring 2007

Prof. Mozaffar Khan

MIT Sloan School of Management

Citibank

- Return on Investment (ROI) is commonly used for divisional performance evaluation
  - and implicitly compared to cost of capital, so that the EVA concept is implictly 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.

Citibank

- 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.

Citibank

- 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?

Citibank

- 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?

Citibank

- 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.

Citibank

- 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.

Citibank

- 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 <u>for the branch</u>.
    - 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 <u>for the branch</u>.
    - Effect of low quality is unlikely to show for a few years or several years (depending on composition of customer base).

Citibank

- 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?

Citibank

- 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 <u>her</u> 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 stores at one branch.
- To align goals, there must be congruence along the reporting chain.

Citibank

- 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.

Citibank

- 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.

Citibank

- 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.

Citibank

- 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.