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MANAGEMENT CONTROL SYSTEM

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Incentive Systems

Chapter 9

MANAGEMENT CONTROL SYSTEM

Section III

Financial Results Control Systems

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MANAGEMENT CONTROL SYSTEM

Chapter 9

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INTRODUCTION

The important of **incentive** system

- because it informs and reminds employees
- about what areas of the result are desired, and
- motivate them to achieve and exceed performance targets

Examples of positive and negative rewards

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Positive rewards	Negative rewards (punishments)
Autonomy	Interference in job from superiors
Power	Loss of job
Opportunities to participate in important decision-making processes	Zero salary increase
Salary increases	Assignment to unimportant tasks
Bonuses	Chastisement (public or private)
Stock options	No promotion
Restricted stock	Demotion
Praise	Public humiliation
Recognition	
Promotions	
Titles	
Job assignments	
Office assignments	
Reserved parking places	
Country club memberships	
Job security	
Merchandise prizes	
Vacation trips	
Participation in executive development programs	
Time off	

PURPOSE OF INCENTIVES

Three types of Purpose / **Benefit** of incentive in management control system:

1. informational
2. Motivational
3. Attraction and retention of personnel

PURPOSE OF INCENTIVES (CONT'D)

Three types of Purpose / **Benefit** of incentive in management control system - 1. **informasional**:

- the rewards attract employees' attention and
- inform or remind them of the relative importance of often competing results areas.
- Effort-directing purpose

See 2. **motivational**:

PURPOSE OF INCENTIVES (CONT'D)

Three types of Purpose / **Benefit** of incentive in management control system

– **2 motivational:**

- some employees need incentives to exert the extra effort
- required to perform tasks well.
- Effort - **inducing** purpose

See 3. Attraction and retention of personnel

PURPOSE OF INCENTIVES (CONT'D)

Three types of Purpose / **Benefit** of incentive in management control system – **3. Attraction and retention of personnel:**

- Performance-dependent rewards are an important part of many employees' total compensation package.

PURPOSE OF INCENTIVES (CONT'D)

Incentive systems also serve **noncontrol** purposes:

1. decreasing cash outlays when performance is poor
2. smoothing earnings – compensation expense is lower when profits are lower

MONETARY INCENTIVES

Three main categories of monetary incentives:

1. performance-based **salary** increases
2. short-term **incentive** plans
3. Long-term incentives

MONETARY INCENTIVES (CONT'D)

Three main categories of monetary incentives – 1. **performance-based salary increases**

- The term "performance-based" is key to distinguishing incentives from assignments

2. rencana insentif jangka pendek

MONETARY INCENTIVES (CONT'D)

Three main categories of monetary incentives - **2. Short-term incentive plans:**

- Provide higher rewards for employees who make the greatest contribution to the company.
- Cash payments based on performance measured over a period of one year or less:
 - Annual incentive payments,
 - bonus.

3. Long-term incentives

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives:**

- based on performance measured over periods greater than one year.
- Objective is to reward employees for their role in maximizing the firm's long-term value.

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives:**

- Multiple forms:
 - Stock **option** plans.
 - Restricted **stock** plans.
 - Performance **stock** plans.
 - Stock **appreciation** plans

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives -**

Multiple forms -- Stock **option** plans:

- the right to purchase a set number of shares of company stock
- at a set price during a specified period of time.

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives -**

Multiple forms -- Restricted **stock** plans:

- they eligible employees do not have to spend cash to acquire the stock,
- but selling the stock is restricted for a specified period of time
- contingent upon continued employment.

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives -**

Multiple forms -- Performance **stock** plans:

- to provide stronger incentives to maximize shareholder value
- by raising the bar for stock price improvements
- before the options become exercisable.

MONETARY INCENTIVES_(CONT'D)

Three main categories of monetary incentives - **3. Long-term incentives -**

Multiple forms -- Stock appreciation plans :

- Stock appreciation rights (SARs) are a type of employee compensation linked to the company's stock price during a preset period.
- Unlike stock options, SARs are often paid in cash and do not require the employee to own any asset or contract.
- SARs are beneficial to employers since they do not have to dilute share price by issuing additional shares.

INCENTIVE SYSTEM DESIGN

Incentive system design:

1. The amount of incentive is determined (*Formula*)
2. Shape of incentive – Performance incentives
3. size of incentive -

INCENTIVE SYSTEM DESIGN (CONT'D)

Formula – It is important for incentive systems to have an incentive formula.

- Also a part can be subjective.
- Superiors sometimes leave contract terms implicit because they may not know how to describe the bases for the rewards or the weighthenings of importance.
- They want to keep the contract flexible, also to ensure that employees do not stop when the target is reached

INCENTIVE SYSTEM DESIGN (CONT'D)

Formula - Employee risk

- can be decreased
 - if it allows adjustments for factors outside of the employee's control
- but increased
 - if evaluation is based on different factors than assumed,
 - if the evaluators are not trusted and
 - if employees try to influence their evaluation.

INCENTIVE SYSTEM DESIGN (CONT'D)

Formula - Shape of incentive

- When the reward promises are formulaic, the link between rewards and the bases on which they are awarded is often determined by a rewards-results or incentives-performance function.
- Lower cutoff / threshold:
 - below some significant fraction of targeted performance, managers are promised no incentive compensation for performance.
- Upper cutoff / cap:
 - no extra rewards are provided for any additional performance above the cutoff.

CRITERIA FOR EVALUATING INCENTIVE SYSTEMS (CONT'D)

Formula - size of incentive

- Variable pay should motivate and is likely to attract employees who are confident about their abilities.
- A risk premium (at-risk pay) should be offered if outcomes are not totally controllable by employees.

CRITERIA FOR EVALUATING INCENTIVE SYSTEMS

For ideal motivation, a system of performance-dependent rewards:

1. The rewards should be valued.
2. The rewards should be large enough to have impact.
3. The rewards should be understandable.
4. The rewards should be timely.
5. The rewards should be durable.
6. The rewards should be reversible.
7. the rewards should be cost efficient

GROUP REWARDS

- Group rewards are good when the tasks are mutually connected.
 - However they can also create the free rider effect.
- Group rewards can produce a beneficial form of cultural control.
- Team members may monitor and sanction each other's behaviors and produce improved results.

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