Berkshire controls analysis for management accounting

Founded in 1852, Berkshire Industries PLC grew from a brewery serving local pubs to a medium-sized publicly held corporation focused on the beverages and snack foods industry. The brewery used a decentralized strategy in terms of the structure of its operations, focusing on four divisions; beer, spirits, soft drinks and snack foods. Up until 2000, the company's annual planning process related to the incentive systems was a bottom-up process where each operating divisions proposing their earning targets and how they will achieve them. Each division was united under a common goal: maximize shareholders' value. Berkshire's Objectives of its Incentive Plan

Ever since Berkshire went public, it instituted an incentive plan for division and lowel-level managers. The system was built to achieve three objectives; to ensure the congruence between management and shareholders' interest, to provide additional motivation for managers to work harder and to provide a simple and objective performance evaluation. In comparison, division and lowel-level managers' objectives are maximizing their annual revenue and having the necessary power and understanding to influence their yearly compensation. It is senior management's responsibility to make sure there are sufficient incentives for the managers to behave in the company best interest and maximize shareholder value. Unfortunately, this was not the case under both the old and new incentive plan. The Desired Characteristics of an Incentive Plan

An incentive must fulfill several important criteria to be considered effective; it should be valued, understandable, timely, durable, reversible, cost-efficient and congruent. However, on the case of Berkshire, the employees and management explicitly prioritized some of the criteria. Berkshire is a 150 year-old company. With its established brand, it is reasonable to assume that management must have a definite long-term plan for the company. Management prioritizes the durability and the reversibility of the incentive plan. Also, because of the current recession, it must ensure that the incentive plan is cost-effective for the company.

Finally, it was explicitly expressed by the board that they valued an accurate, simple and objective performance measurement that " goes up when shareowner value is created and goes down when value is destroyed" It was explicitly expressed by the managers that they want to understand how their compensation was determined in order for them to have maximum control over their division. Also, a significant and timely compensation will ensure their full cooperation in aligning the firm with their own objective. It is crucial that the incentive plan can provide for both the needs of the Board and managers in order for the incentive plan to work properly.

Issue I – Old Incentive Plan Based on EPS The lack of shareholder value creation at Berkshire can be traced back to their old incentive plan based on EPS. The main issue regarding EPS as a performance measure was its lack of congruency towards the company's objective of maximizing shareholder value. EPS is not a very comprehensive performance measure as it neglects a division's cost of capital and investment, leading to a minimal effect on the company's share price. The lack of shareholder value creation was noticed by senior management as " EPS had been improving steadily (9% annual) over the last decade but the share price had increased slightly during that time frame".

Secondly, the EPS incentive plan was very subjective as the plan was influenced by an annual incentive compensation group of forty members, all of which were senior managers at Berkshire. This lack of objectivity allowed managers at Berkshire to significantly impact the compensation committee headed by members of the Board of Directors. The lack of independence was further noticed as division managers were able to set their own goals with little intervention from the compensation committee. These inventions also created “ politicking” over manager’s evaluations leading to misspend time and a loss of productivity. The issue led the Board to believe that management had too much power in overriding decisions as “ too many bonuses where being made, giving managers bonuses even in years where their entity did not perform well”.

Lastly, the use of the profit reserve actually demotivated division managers and stunted shareholder value creation. The profit reserve acted as a protective cushion for division managers as it filled any gap caused by the manager’s inability to meet his performance targets. The reserve is a form of manipulation and creates a lack of accountability as divisional managers’ performance is hidden from financial statement users such as shareholders. Even with the cushion, shareholders were not seeing any value being created. Issue II – New Incentive Plan Based on “ Economic Profit”

By viewing the new incentive plan using “ Economic Profit”, senior management has noticed that a lot of the same problems with the old plan are still present. The main issue with the new plan is that there is still a lack of congruency between “ economic profit” and shareholder value. As “ economic profit” increased from the beginning of 2000 to the end of 2002, the share price of Berkshire actually decreased consistently over that time frame. The causation of this incongruence might steam from the consulting firm's decision to make only two out of their a hundred suggested adjustments to the new plan in order to make it simpler. The new incentive plan could therefore be missing all the necessary components in order to create shareholder value.

Even though the plan is more precise and objective than the old plan, there is a lack of understandability from managers as to how it works, even after training sessions. The consulting firm considers the performance measurement " simple" but the managers still do not understand how to compute " economic profit" and some even continue to manage their division under the old EPS system. With Berkshire paying for expensive training sessions and consulting fees, management may need to consider the cost-effectiveness of the new plan.

It can be argued that the incentive plan lacks controllability in terms of management influence on " economic profit" with the absence of external factor considerations. This issue is of significance to the Spirits Division at Berkshire as the recession caused a shift in demand and lowered " economic profit" which was out of the division manager's control. This scenario creates discouragement and a lack of motivation among division managers as they cannot control their performance targets due to the current economic climate. These bad attitudes can also lead to game-playing as some managers are taking advantage of CLA's adjustments to advertising by overspending the account as it is adding back to their Adjusted Net Operating Profit after Taxes and amortized slowly over five years. These actions can be seen in the exhibit 1 as advertising expense rapidly increased after the implementation of the new incentive plan, providing large bonuses to managers for poor performance. The long-term consequences of these earnings management techniques can be devastating to shareholder value as it is short-term focused and does not align shareholder and management objectives.

Lastly, the implementation of the bonus bank also has a demotivating effect on divisional managers as the negative bonus balance is a threat to the retention of risk-averse managers. Significant annual losses reported by divisional managers can lead to a large negative bonus balance which stays with the manager even if he or she transfers into a new division. This issue is especially important to the Spirits division as uncontrollable factors such as the economic recession have created deep negative bonus banks. These managers will be highly demotivated in turning their division around if there is no bonus incentive in the short run.

Alternative I – Adjust the EPS Incentive Plan One of the major considerations of reverting back to the old plan is that EPS as a performance measurement is already comfortable with managers as they understand it, are used to it and are perceived to control it. The bottom-up target setting feature was beneficial to the decentralization strategy of Berkshire. These factors allowed the EPS incentive plan to be more cost-effective.

Adjustments could be made to the compensation committee by providing more influence and independence in the target planning and performance evaluation of management. This will allow greater objectivity, less “

politicking" and a greater correlation between performance and bonus. The profit reserve should also be removed to provide greater accountability to under-performing division managers and to provide better transparency to shareholders.

Unfortunately though, the old plan still has a major drawback as it lacks congruence between increases in EPS and increases in shareholder value, with no variables to account for risk and investment.

Alternative II – Adjust the " Economic Profit" Incentive Plan If senior management can persuade lower level managers to accept and understand the " economic profit" measurement, the plan would be uniformly implemented across all divisions, increasing economic profit which may lead to an increase in share price. This is already a difficult task as the company has already enforced training sessions for managers which were ineffective. A change in the " tone at the top" and proper training in financial measures might provide a solution to lower management's disregard but management should consider the cost/benefit of this implementation.

Secondly, the removal of the bonus bank with the replacement of a compensation committee would remove the negative attitudes and demotivation seen by some division managers and would open up a communication channel between management and the board to help mitigate the effects uncontrollable factors.

Lastly, the " economic profit" measurement itself might not be comprehensive enough in order to increase shareholder value, which leads to a paradox. CLA believes that the performance measure can lead to an increase in shareholder value but decided to only to implement two adjustments out of the recommended one hundred for the performance measurement. This can be supported as the plan does incorporate capital and the cost of capital unlike the EPS plan but lacks the proper adjustments. The flip side is that this would lead to even more confusion by division managers and less acceptance towards the plan.

Alternative III – Create A New Incentive Plan using ROI & Stock Options By analyzing the first two alternatives for Berkshire, it is obvious that there is still an inherent flaw in the incentive plan caused by a lack of congruency between the performance measure and the objective of maximizing shareholder value. We suggested that Berkshire removes its existing incentive plan and considers a third alternative of an incentive plan based on ROI for division managers and stock options for senior management.

ROI is a great performance measurement for decentralized organizations like Berkshire. Since each of the four divisions within Berkshire are highly autonomous and are accountable for the management of their assets and profit that they report, division managers are more able to control their performance measure. Managers can now control their own success and are likely to be highly entrepreneurial and motivated.

ROI is a much simpler performance measurement tool than the “ economic profit”. This means that managers are more capable of understanding, computing & influencing ROI for their division and would be more willing to accept the new plan. This simplicity can lead to a cost-effective incentive plan. ROI can also be decomposed into multiple accounting variables if senior management or the compensation committee is interested other areas of the division such as asset turnover or Profit as a % of sales. This flexibility can help senior management make more informed decisions by comparing ROIs across divisions and competitors while still maintaining a simplistic performance measurement.

ROI also accounts for each division's investment unlike EPS and " economic profit" and by comparing ROI to each division's cost of capital, the incentive plan also includes risk. We now have all the necessary variables to create a precise incentive plan and link ROI performance with shareholder value. The new incentive plan can therefore solve the congruency issue faced by the two previous plans.

ROI does have its downfalls as it can create management myopia and suboptimization. To mitigate the suboptimization threat, preaction reviews of capital budgeting and strategic planning can help align division and corporate interests. Investment opportunities in each division can be reviewed by senior management to determine what actions are in the best for the corporation. The investment variable for ROI can be measured using Gross Book Value to help mitigate the risk misleading performance signals and the profit variable will include expenses such as advertising to reduce potential game-playing seen in the " economic profit" incentive plan.

An active and independent compensation committee should be enforced to manage uncontrollable factors facing division manager's incentive plan and evaluate division performance in order to provide a unbiased bonus. The implementation of the compensation committee can also act as a cap to the bonus plan as some of the division are coming out of a recession and therefore managers might receive undeserving compensation if not monitored and capped.

Lastly, stock options do have the close correlation between change in share price and change in shareholder value but CLA stated that “ stock-based incentives are not an effective tool for motivating division managers” as they have a modest impact on the overall share price. Although this is true for lower level management, senior management is in charge of the strategic planning of Berkshire and is also in control of the finance, human resources and other administrative functions in the organization. Senior management can therefore influence share price more than division managers and should therefore compensated using stock option plans to motivate them and to align their objectives with maximizing shareholder value.

The type of stock option plan should be specific in terms of its restrictions & vesting period, as well as the amount of stock to issue as we want senior management to feel like owners and we want to motivate them over the long-term, especially now that some divisions are coming out of a recession. This long-term focus will influence senior management to properly review investment opportunities presented by division managers and therefore reduce management myopia created by ROI. Recommendation

We believe that the new incentive plan using ROI and stock option plans is the best alternative as it is understandable, timely, objective, cost-effective, controllable and valued. Most importantly, ROI and stock options provide congruency among shareholder and management objectives and enforce the desired behaviours of firm value creation. Although ROI does have its flaws, management understandability & goal congruence far outweigh these costs. With proper oversight using preaction reviews & an independent compensation committee, as well as accounting adjustments and stock options, shareholders can help reduce management myopia and suboptimization.