

1/9/25

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Leo's Four
Plex Theater

Personnel Controls

Training?

Hiring nephew?

Young employees / culture

No supervisor presence (people watching people)

Nepotism

Manager / supervisor / owner relationships

Role of trust

Modeling behavior to others

Wages attract a certain worker profile

Action Controls

Color coding tickets

Dates on tickets (supply waste happening)

Manager signs passes

Ticket categories

Ticket times / shows

Lock box

Cash reconciliation

Turnstyle (physical controls)

Attendant at turnstyle

Physical ticket

Results Controls—tied to an outcome with compensation

Free passes to employees (perhaps too many)

No penalty for cash reconciliation / no reward

Fire / dismiss employees

What is the BIGGEST managerial problem?

Option 1) the owner is not present

Option 2) lack of accountability / consequences

Option 3) clear expectations to employees

Option 4) hiring family members

Option 5) no structure / business plan from manager

Option 6) cash discrepancy / value lost

What is the one action you would take tomorrow?

Assign seats (system change)

Hire an awesome UVU MBA grad as manager (personnel change, expensive)

Clear performance measures at job spots & incentives (system change, \$)

Make manager think like an owner (profit share) (giving away equity)

Count \$ at the end of every shift. Clear accountability. (direct solution, straightforward, not costly)

One on one with manager.

What is the final goal? MCS is designed to attain the goal.

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Puente Hills Toyota

Describing the setting / key facts?

High performing car dealer

One of 7 dealers under owner's management

Vehicle repairs / new car sales / used car sales

70 / 30 split on new cars / used cars

Profit margins vary by area

Multiple compensation structures

Used v new

Commission from additional sales

Management problem: keep team members
focused / same direction / prevent problems from
spreading

Customer service index is important—vehicle
allocation to dealers; linked to incentives—but
there are problems.

Toyota punishes if too low for too long

Gaming of the survey—filling it out themselves

Survey timing

Service department has system to prevent corner
cutting

Pay based on flag hours—can complete faster

Service / sales linked in the business

80 / 20 split on employees

Organizational structure and the **Decision Rights**

Responsibility Centers

1a Cost Center

Human resources

Parts manager

Office staff

Mechanic

Marketing / advertising

1b Revenue Center

Service representative
Mechanic
Sales reps (new)

2 Profit Center

Finance manager
General sales manager
General service manager
Body shop manager
Sales reps (used)

3 Investment Center

General manager

Accountability vs Authority?

Exhibit 3—what line is the bonus based on?

Sales manager—line 59 / line 62—Departmental profit AFTER overhead allocations

Service manager—line 33--departmental profit BEFORE overhead allocations

Why the mismatch? Why the alignment?

Make sure everything is covered...

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Witsky and Associates

Step 1: Identify the key facts

Who?

Brayton

Brayton's family

Witsky and associates

Client firm

Jeremiah

Supervisor (Pete)

Priscilla (CFO of Witsky)

Warehouse personnel

Location tracking data company

What?

Brayton caught being dishonest / misreporting / not
at places he said he would be

Assigned to do a time and motion study

Deliverable is a report

Tracking of location

Personnel problems interfering with work

Client concern about personnel work efficiency

Interview with Priscilla about the problem

30 hours on-site expectation

Discrepancy on where he is

Confronting Brayton about discrepancy

Pete / Jeremiah—concern is raised

When?

Month of June (observation period)

Phone call on July 1st

Pete / Jeremiah conversation
Meeting in Pete's office
Around the clock hours (24/7)
2 years after starting at company (Brayton)
Report turned in
Checking computer records

Where?

Where was Brayton when not on the job?
Riverside, CA
 Jurisdiction / rules / laws
Location tracking gives all the "where"
Warehouse and distribution center
Pete's office
Management consulting firm—client relationship
Internet—report information
 What websites?
IT room / tracking data on some server / access the
information
Cell phone
App / software installed on the phone
Only on location once

Why?

Brayton under stress / reaction is tears
By chance / in passing mention of the concern
Legality of using data / Legality of report information
Warehouse personnel not efficient
Brayton only at client once (per Jeremiah)
Personal struggles / time crunch
Report came in faster than expected
Never used app data before
Contract terms for next year
Witsky pays for the phones
Required to keep phones on

How?

Legal counsel signed off on using the data
Trusted Brayton
Ethical conscious
No accountability / supervision
30 hr / report
Firm policy on app being on
Were other employees engaging in similar behavior?
Brayton had many projects / tight deadlines
Cut corners to manage load
Brayton hoping client doesn't report him

Step 2: Define the Ethical Issue

Is there any harm?

Potential for confidentiality of client info
Witsky and associates losing client trust
Brayton—job status / trust of self and others
Client—report is inaccurate
Witsky—culture
 Could lead to future changes, could hurt future employees

Key question: Should Witsky use the cell data or not to verify Brayton's location?

Step 3: Identify Major Principles, Rules, and Values

Utilitarianism—cost benefits, ends justify means, good of many

Rights & Duties—right to privacy, duty to the work

Virtues—honesty, integrity, mercy, justice.

Step 4: Specify the alternatives

Use the data

Don't use the data

Step 5: Compare Step 3 and 4.

Use the data b/c

Duty to fulfill employment agreement

Important to know truth, but allows for mercy,
performance improvement plans

Want to verify data (better for all).

Right to privacy is respected (only used when
issues arise as agreed to in contract)

Justice, what Brayton did is wrong, stolen
time.

Obligation (duty) to use app.

Cost of lawsuit is high / firm could be hurt

Don't use the data b/c

Could have got to the same end without using
the data

Truth / honesty

No precedent

Impact on future employees (training, policies)
(the many)

Duties (absence of them)

Step 6: Assess the Consequences

Use of data

Affects Brayton's future

Other employees start asking questions

Legal risk / liability

Brayton sues for wrongful termination /
discrimination

Policy changes / procedure changes on use
of tracking data

Gaming will happen
No impact
Increase productivity / improve trust
Could reveal accuracy of the data / usage of
the data

Not use the data
Miss out on the story
Will come again
Client will sue (legal risk)

Step 7: Make a decision

EyeOn Pharma

1) What are the Critical Success Factors?

1) Innovation, new medicines. (1 in 10,000)
a) A lot of new ideas / speed / cost does not matter
b) 1 in 10,000 must be a home run
resource allocation
c) patent / making the drug

2) Hire / keep the right people
A) 80/20 performance
B) play to strengths of the employee

3) FUNDING
A) market share
B) monopolistic rent from patent
C) branding

2) Researchers—How can we measure the productivity /
performance of the individual researcher?

Time?
Tests done / time to complete (tasks)
Peer reviews

Home runs?

Publications / citations

Advancement through phases

Hitting milestones

Progress towards goals (individualized)

Self-evaluation

Grants / funding

Intense hiring process

Tenure system (probationary system)

Jr researcher

Sr researcher (partner)

Poaching

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Philip Anderson

What does "best interest of the client" mean? How does this compare to "suitable"?

Best interest:

- Personalized to each client
- What makes the most money
- Congruence with client's desire/situation
- Optimize money growth
- Minimize financial cost of management
- What is the benchmark (required rate of return)?
- Long term
- Personal statement about client risk preferences
- Customer choice
- Full disclosure / fee structures
- Best interest will be different for each client, not one size fits all

Suitable:

- Generic advice
- Will make money but maybe not the most
- Could be just convincing customer of something
- Maybe less confident positions
- Subjective
- Short term
- Financial advisors benefit?
- Push products that firm runs and gets profits, but are comparable products
- Firms still need to make profits to be sustainable
- Limited disclosure

How far can firm act in their own best interest before it is illegal or unethical?

Power tends to be abused...NEED CONTROLS!

SEC

Department of Labor...?

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Zumwald

3 options for X73 Display

- 1 Heidelberg 140,000
- 2 Bogardus 120,500
- 3 Display Tech 100,500

Qualitative or strategic differences?

Heidelberg—own company, vertically integrated

- Capacity internally—70%

- Fixed labor costs

- Half of sales to ISD (big customer), yet the other half is being sold externally

- Complex internal relationships

- Care about the product, wants the business.

- Engineers participated in the design.

- EU

Bogardus—high quality products, new product for them. Dutch

- Existing relationship, long time supplier

- EU

Display Tech—new entrant, strategic low pricing for market share. Pricing might rise in the future.

- UK, not an EU

Zumwald—5%—this is small potatoes. Key precedent for their management structure (decision rights)

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Vitesse Semiconductor

35%--hurdle rate? What is this?

Return needed for the project to be "worth it"

Does it meet a threshold / requirements?

Does the project fit within the business model?

Minimum acceptable return to take a project

Financial rate / benchmark

Desired return?

Screening tool

Is the hurdle rate an arbitrary number or where does it come from?

Weighted Average Cost of Capital (WACC)

Assets = Liabilities + Owner's Equity

$$WACC = \left[\frac{\text{debt}}{\text{debt} + \text{equity}} \right] * \text{Cost of Debt} * (1 - \text{tax rate}) + \left[\frac{\text{equity}}{\text{debt} + \text{equity}} \right] * \text{Cost of Equity}$$

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Harwood Medical

Why change plans?

Consider more factors beyond operating profit

Differences across divisions

Other key performance indicators

More dimensions of performance can reward more areas of effort / performance

Increase efficiency—deliveries done better, with less time.

Success measures vary, new plan evens playing field

Maintain competitiveness in the industry

Prepare for growth to make more money

To motivate behaviors which will improve profits.

- Breakdown to specific goals/actions

- Employee buy in to managerial / employee actions

Time horizon focus? Operating profit can lead to short-term focused actions. New plan focuses on long-term drivers of value / profits.

Incentives counterbalance each other.

Weighting of metrics

- Sales returns

- Scrap and rework

 - Carry the highest weight

What are the unintended consequences of the new system?

Strategy surrogation—when the metric becomes the goal instead of the end goal.

Base salary can help mitigate this.

1 Budget system

2 Performance reporting system

3 Incentive system

When viewing results, need to consider potential exceptions?

Are any of these exposed to gaming concerns?

- 1 Scrap/rework
- 2 Patents filed
- 3 Customer satisfaction
- 4 Delivery
- 5 Sales returns

All of these could possibly be gamed.

Company strategic goals?

- 1) quality
- 2) customer service

What is success in this business?

Profit!!!!

To maximize long-term shareholder value

Performance measures should be audited. (internal auditor)

Framing of the reward / penalty

There is bonus given—Deliveries can \$0, \$2k, \$5k.

There is penalty given—Customer sat. Reduce by \$5k

There is the combo—sales returns. \$5k bonus / 50% of overage penalty

Are people more motivated by positive benefits or negative consequences?

Prospect theory—Kahneman and Tversky

Value small gains / small losses differently

Think in terms of Utils

Individual personalities can influence responsiveness.

Sociotropy—need for affirmation and approval of others

Line of work / setting can influence acceptable norms / practices

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Berkshire

Why new plan?

- Nit picky / managerial disputes
- Align with shareholders
- Award bonuses to manager adequately while also benefiting shareholders
- Reduce subjectivity
- Happy shareholders—stock price is higher
- System that reflects more on managers' actions

Old plan: earnings per share.

Why does EPS not fit?

Weakness

- No consideration of the cost of capital
 - Clear the hurdle rate that meets cost of obtaining resources for the business
- EPS may not reflect the value of the company?
 - Price / earnings ratio—multiple
 - Discounted cash flows—Ohlson Juettner model
- Target for EPS can vary with market conditions / may be hard to use as benchmark
 - Analyst expectations can inform evaluation of an actual EPS measure
- EPS compared to industry is hard to use
- Possibility for gaming / politicking
 - Denominator: share buybacks
 - Numerator: earnings management
 - Accounting practices
 - Real-earnings management (cutting costs)
 - Could be exposed to dilution

EPS is a historical

Limited time horizon

Strengths

Simple, understandable

Effort can lead to better EPS

Should be connected to firm value

Earnings-per-share = net income available to common stockholders / common shares outstanding

Economic Profit

Residual Income Model

Leftover Income = Income - (Assets*Capital Charge)

Weakness

Too complicated, management is confused!

Executive, firm level measure. Middle managers may struggle to connect with this

Harder to factor in competitive environment

High chance of gaming—income and asset book value

Might not be connected to stock price?

Focused on profitability, not growth.

Investors get EPS, not economic profit.

Consultants are not good

Are the adjustments appropriate?

Reflects economic conditions—what is the cause of the measure moving?

Strengths

Consultant endorsed

Performance targets are more clear, easily adjusted

Clear upward incentive

Good signal to managers

Capital charge

Competitive market for debt / equity

Encourages continuance improvement

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Johansen's

New Scorecard

1. Financial—profitability targets (gross margin / net income); Year over Year growth. (chance of "fluff", manipulation, incentive, positive year over year incentivizes upward gaming). Financial rating was 1 to 5. Is meets expectations okay?
2. Customer Service—survey online / bottom of the receipt (ignoring, gaming, this is terrible, captures the end-points of the distribution—may not be representative)
3. Leadership—360 degree feedback, also subjective from regional manager (could be influenced by group dynamics, outliers with strong feelings,
4. Strategy—subjective by regional manager; alignment (personal preferences, silly!, know it is working if #1 Financial and #2 customer service is doing well, redundant measure, may not be relevant to store manager).

Training

Operational metrics

Customer service is the key brand differentiator.

Risk of turnover weighs heavy, want to keep best staff.

Subjectivity allow Jill to game the subjective ratings

Requirements: for an overall 5

1. Get at least a 3 in all categories (met)
2. Get a 5 in 3 of 4 categories (met)
3. Get a 4 or 5 in customer service (not met)

Why should Jared Clark get a 4 (other regional managers)?

Customer service is critical aspect—Jared fell well short of the expectation.

Comparison to other store managers shows how far he is behind.

Strategic goals would be undermined

The scorecard is what it is—he got a 4.

Ruin the integrity of the system if he didn't get a 4

Existing scorecard calibration

Poor precedent / manager credibility

Jill's bonus is based on store finances—remove bias.

Following established standards / rules helps avoid bias

Can't change system just for one employee

Disservice to Jared to give an unrealistic score—hinders personal growth if improvement needs is hidden

Protects the firm by having realistic performance ratings

Why should Jared Clark get a 5 (Jill's argument)?

Store is performing so well so we can make an exception

Financial performance is hitting above the stretch goals

Exhibit 8—turnover rate has greatly improved; responds well to feedback

Emphasize customer service scores are improving

Human side / managing relationship

Store demographics (Orange county, older customers, wealthy customers, don't want to take a survey)

Customer base is loyal

Manager discretion is allowed!

1st year of the new scorecard, need to allow time to implement and adapt, 1 year forgiveness

Competitive job offer with a raise—market justification of value

What was Jared's expectation / knowledge of the performance system?

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Howard Building Corp

What is project accounting? How is different than firm-level accounting?

Specific project vs entire company (scope)

Track and assign costs to specific project

Projects are usually talked about as P&Ls (Profit & Loss statements) vs a firm with balance sheet, income statement, etc.

Projects have an end, but could be longer or shorter than a fiscal year! Firms are on-going, impose a fiscal-year reporting period.

Projects have a lot of specific, itemized plans vs firm is all about aggregation

Projects have differences in budget / resource allocations versus a firm raises debt / equity

Projects often have budgets and standards (expectations)

Project measures are focused on decision making; firm level are more about efficiency

Audiences differ—firm financial are for shareholders; project financials are internal manager

Firm is focused on historical information. Project accounting is real-time.

Firm accounting is GAAP focused. Project accounting is flexible.

Performance measures? How do we know a project is successful and what measure tells us so?

Profit. Profit margin. Important, but not essential.

Relationship with customer.

Budget costs compared to actual costs.

Capital budgeting metrics

- WACC

- Net Present Value

- IRR

- Payback period

- ROI

Management of change orders

Use and estimate of contingency fund

Loan to funding ratios

Tasks are completed with expected quality

Tasks are completed on schedule

- Opportunity costs

Staying within maximum price (customer's budget)

Customer happiness

Exposure / PR—loss could be considered Advertising Expense

Reallocation of resources in the middle of a project

Updating estimates mid-completion

Experience and training—skill development,
demonstration of competencies / abilities

Future project improvements

Plan changes

Estimates / predictions

Process updates / precautions

Learning curve

System of yearly updates / changes

Accuracy of cost estimates / realizations (variance
analysis)

Capacity rates

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Arrow Motor
Car_Actual

Arrow Motocar

Board of Directors

What is role the board of directors at a public firm?

Oversee the company, best interests of the shareholders

Look at for employees as well

Role of independent v dependent director

Public requires a majority independent

SEC has rules/oversight for directors/firms for public firms

Directors "act" for the shareholders—proxy

Fiduciary duty—legal obligation to act in the best interest of shareholders / behavioral controls

Oversee operations / objectives—even firm strategy

Policies.

Approvals.

Hire / Fire the CEO

Oversee executive compensation

Equity

Performance targets

Boards are voted on by shareholders

Hire and oversee the audit

Identify and manage risk (controls in place to mitigate)

Principal (Owner/Shareholders)--Agent (Manager / CEO)

1. Information asymmetry (they know different things)
2. Moral hazard (self-interested)

Principal (Diffuse ownership)--Agent (Board of Directors)--
Agent (CEO)

First model: Principal-Agent

Actual model: Principal-Agent-Agent.

Principal is largely powerless and not influential

Imbalance in how the company works

Interests may not be aligned

Delegation of responsibility—who is doing what?

Game of telephone—messages get mixed up

Continuity—CEOs often transition onto boards

Stock-based compensation is used.

Committees

1. Compensation committee
2. Audit committee
3. Nomination committee

Average public firm has 9.2 directors

Has to have a majority independent directors

1. Never worked at the firm
2. Not be related to key employees (VP level and up)
3. Never have worked at key supplier or service provider
(auditor, consultant, banker).

66% of directors at public firm were independent

Arrow's Board

Independent (outsider) v (insider)

Expertise

Access to information

Repko (founder, owner, great access to information, knowledge
of the product)

Limited information that was given to the rest of the board.

Standell (financial consultant, knows finances)

Rosenfield (bank representative, expert in finances, protect lender interest, make sure loans get repaid)

Jacobs (attorney, long-time associate, there to support Repko, conflict of interest?)

Zuraidi (represents Mr. Megat, investor representative, replace Rosenfield who resigned)

West (self-employed consultant, replaced Jacobs, long-time associate of Repko, key support person in order to take action)

Conflict—causes?

Personal expenditures--overstating

Rationalizes spending, trips for company or personal use?

Overall management style

Using company product in his own home?

Procrastinates, poor planner

Not receiving relevant info

Not paying payroll taxes

Financial statements not issued

Focused on personal image, and raising money

Neglected engineering and production

Compulsive, obsessive personality and bad mouth

Business plan is super optimistic—presenting this to investors—potential for fraud?

In it for the money

Visionary

Hmm...exhibit 2 says he can be a bad manager?

Is anything on this list a fireable offense?

Pac Sun

Sarbanes-Oxley Act of 2002

Creation of the PCAOB (Public Company Accounting Oversight Board)

1 set audit standards

2 audit the auditors

Audit committee must be independent and financially literate

Executives Certification

- 1 Reviewed financials
- 2 are fairly presented
- 3 No untrue statements
- 4 Responsible for the controls over financial reporting
- 5 evaluated controls

Section 404—formal evaluation of internal controls

Opinions from the auditor of management's evaluation

Unqualified opinion—this is good

Qualified opinions

Deficiency—controls that do not permit timely prevention or detection of misstatements

Significant Deficiency—adverse effect on the financial statements that is more than a remote likelihood that is more than inconsequential

Material weakness—the effect is material

First year of SOX, 16% of firms received a material weakness.

3/4 of the weaknesses were found by auditors

What happens after a material weakness?

Stock plummets

Class action lawsuits

Management turnover

Auditor turnover

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Wired

Don

1—capital expenditure (CEO would like)

Organic growth.

Looks better for the business

More natural growth

Signal of managers ability

Appearance purposes to the market

Market will value the firm higher.

DR Assets \$12 million

CR Cash \$12 million

Later on,

DR Depreciation / Amortization Expense

CR Accumulated Dep. Or Amortization

2—Business acquisition (Don's preference b/c of customer lists asset rights). This is the right way!

Inorganic growth.

Had to go buy another business

More rapid scaling

Indicates holes or inabilities

DR Assets \$12 million

CR Cash \$12 million

Later on,

Earn out

DR Expense

CR Cash

Or

DR Depreciation / Amortization Expense

CR Accumulated Dep. Or Amortization

Don's options

- 1 do what his boss says
- 2 Don can whistleblow
- 3 Don can account for it as an acquisition
- 4 Don gets fired
- 5 seek outside counsel
- 6 talk with the audit firm
- 7