

According to Tru-Fit executives, the factors critical to success in the OEM market were (1) the ability to design innovative and dependable parts that met the customer's performance and weight specifications; (2) meeting OEM delivery requirements so that the OEM company could minimize its own inventories; and (3) controlling costs, since the market was very price-competitive. In the AM market, availability was by far the most important factor, followed by quality and price.

Approximately 50 Tru-Fit line managers and staff group heads participated in an incentive bonus plan, which worked as follows. First, the size of the corporate-wide bonus pool was established; its size was related by a formula to corporate earnings per share. Each participant in the bonus plan had a certain number of "standard bonus points"; the higher the participant was in the organizational hierarchy, the more standard points he or she had. The total of these points for all participants was divided into the bonus pool to arrive at a standard dollar award per point. Then this amount was multiplied by the participant's number of standard points to arrive at the participant's "standard bonus." This standard award could be varied upward or downward as much as 25 percent at the discretion of the participant's superiors.

In the case of a plant manager, the standard award was also adjusted by a formula that related percent of standard award to the plant's profit variance. For example, if the plant's actual profit for the year exceeded its budgeted profit by 5 percent, the plant manager's bonus was raised from 100 percent of standard to 110 percent of standard. In making this bonus adjustment, the plant's actual profit was adjusted for any favorable or unfavorable gross margin variance caused by sales volume to the AM Marketing division being higher or lower than budgeted. For example, if all of a plant's favorable profit variance were attributable to a favorable gross margin volume variance on sales to AM Marketing, the plant manager's bonus would not be raised above 100 percent of standard. Similarly, the plant manager would not be penalized if AM Marketing actually purchased less from the plant than the amount that had been estimated by AM Marketing when the plant's annual profit budget had been prepared.

In general, top management was satisfied with the present performance measurement scheme. In discussions with the case writer, however, they mentioned three areas of concern.

First, there always seemed to be a few disputes over transfer prices from the manufacturing divisions to AM Marketing. Whenever possible, transfers were made at outside OEM market prices. In the case of a part sold as an OEM part several years earlier, the former OEM market price was adjusted upward to arrive at the AM transfer price; this procedure caused virtually no disputes. The problems occurred when the part being transferred was strictly an AM part—one that had never been sold by Tru-Fit in the OEM market and for which there was neither a current OEM outside market price nor a former OEM market price that could be adjusted upward for inflation. Usually, such transfer price issues were resolved by the two divisions involved, but occasionally the corporate controller was asked to arbitrate a dispute.

Second, top management felt that the manufacturing divisions too often tended to treat AM marketing as a "captive customer." For example, it was felt that when AM Marketing and an outside OEM customer were placing competing demands on a plant, the plant usually favored the OEM customer, because the OEM customer could take its business elsewhere whereas AM Marketing could not. (Management was not willing to let AM Marketing sell a competitor's product, feeling this would reflect adversely on the overall image of the company.)

Third, top management felt that both AM Marketing and the three manufacturing divisions carried excessive inventories most of the year. The controller said,

Thank goodness we have a generous Christmas vacation policy here; at least the inventories get down to a reasonable level at year-end when our production volume is low because of employee holiday vacations.

Assignment

1. What would you recommend to top management regarding the three problems they have identified?
2. Are there any matters not mentioned by top management that you feel are problematical?