**388 CHAPTER 10** ➤ **STATIC AND FLEXIBLE BUDGETS**

A dilemma that individuals face is whether to be truthful when it appears that a project is

overbudget. Being overbudget typically means that actual costs exceed budgeted costs or that

a planned time line will not be met. People often delay reporting an overbudget condition either

because they believe they can catch up later or because they wish to delay negative

repercussions. Unfortunately, information delays prevent managers from responding rapidly

and decisively to delays in project timing and cost overruns, leading to additional dissatisfaction

and inefficiencies.

**FOCUS ON ETHICAL DECISION MAKING:**

**Tiely Reporting of Budget Problems**

■ **Kaizen Budgets**

Kaizen costing is a system developed in Japan and used for products that tend to have decreasing

prices or increasing quality across time, such as home entertainment centers, cell

phones, and computers. **Kaizen budgets** set targeted cost reductions across time, anticipating

market price reductions across the life of a product. In addition to cost reductions, quality improvements

are also targeted. When kaizen budgeting is performed, cost reduction and quality

improvement goals are explicitly embedded in the budgets. For example, Mountain High

Bikes could budget for cost reductions of 15% for direct labor and 10% in assembly time to

meet cost and production targets in anticipation of competitors’ price decreases. In addition,

the company could budget an increase in the quality of components. If the costs of quality

improvements are less than the savings from reduced labor and cycle time, overall costs are

reduced. Therefore, Mountain High Bike’s kaizen budget would reduce the cost of each bike

while improving quality.

■ **Extreme Programming**

Budgets are used for a variety of purposes beyond typical operating plans. For example, information

technology (IT) projects are often managed using budgets developed with input from internal

or external customers and from technical people who manage and perform the work. Communication

is an important priority in these projects because customers often cannot fully

articulate their needs. Furthermore, the scope of the project often faces technical limits or cost

constraints. Traditionally, a relatively large amount of time and money is spent on up-front planning

for IT projects to define the scope, specify the work to be performed, and establish the

budget. IT personnel typically work in an isolated environment away from their customers. The

resulting IT projects often fail to meet customer expectations and exceed budgeted costs. Accordingly,

customers have become disillusioned and less willing to spend money on IT projects.

Recently, many organizations have moved away from traditional budgeting for IT projects.

**Extreme programming** is a new type of IT project management in which customers

and IT personnel communicate and collaborate actively throughout the life of a project. Little

time is spent on up-front planning. Instead, the project proceeds in small steps, and decisions

are made jointly as the work progresses. All parties share knowledge about the

progress and design choices made, setting a tone of trust. Organizations benefit from accurate,

up-to-date information through sources they believe to be reliable. In addition, IT project

resources are used more efficiently because a larger proportion of time is spent on actual

project development rather than on theoretical planning.

**GUIDE YOUR LEARNING 10.6 Key Terms**

Stop to confirm that you understand the new terms introduced in the last several pages.

Rolling budget (p. 387) Kaizen budgets (p. 388)

Activity-based budgeting (p. 387) Extreme programming (p. 388)

For each of these terms, write a definition in your own words.

**CHAPTER REFERENCE**

See Chapter 13 for more details

about kaizen costing.

**BEYOND TRADITIONAL BUDGETING 389**

Suppose a CPA firm establishes a budget of professional hours for a particular audit job. The

hours are broken down by audit area, and one area is the valuation of inventory and cost of

goods sold. During the last year, the audit client adopted new procedures for assigning product

costs to individual units. The audit budget includes extra hours for the estimated time needed to

document and assess the reasonableness of the new method. Many factors could cause this part

of the audit to be overbudget. Consider the following two scenarios:

**1.** The client failed to establish appropriate records needed to easily audit the new method, and

this part of the audit will require more than the budgeted time to complete.

**2.** The auditor assigned to this part of the audit is inexperienced and is unable to complete the

work in the budgeted time.

Regardless of the reason for the overage, managers in charge of the audit need to be notified

as soon as possible so that they can consider possible ways to realign staff and complete the

total job on time. In addition, in the first scenario the audit firm might be able to bill the client

for the extra work involved if the audit contract includes a provision for such price adjustments.

However, this scenario would most likely require the client to be notified promptly, while the

work is still being performed. In the second scenario, the overage may result in a poor performance

evaluation, especially if the auditor has similar problems in other audit areas. Yet the

overage may be considered reasonable in light of the auditor’s inexperience. Even so, the auditor

should be able to accomplish the following:10

● Develop alternative estimates of time and resource requirements for a project

● Effectively facilitate and control the project process and take corrective action as needed

Therefore, the auditor must quickly recognize an impending overage and formulate appropriate

strategies for completing the task as efficiently as possible. The auditor also needs to keep her supervisor

apprised of the situation and seek help, when needed.

**Practice Ethical Decision Making**

In Chapter 1, we learned about a process for making ethical decisions (Exhibit 1.11). You can address

the following questions for this ethical dilemma to improve your skills for making ethical

decisions. First, *think about situations in which you worked with other people on a project*. Then

think about your answers and discuss them with others.

**Questions to Consider**

**Ethical Decision-Making Process about This Ethical Dilemma**

Identify ethical problems as they arise. Have you ever failed to meet a deadline on a

group project? If so, what were the reasons for

the delay? When and how did you report the

delay to your team members? Has someone

else ever failed to meet a deadline? Does a

failure to meet an agreed-upon deadline create

an ethical problem? Why or why not?

Objectively consider the well-being of others Explore the responsibilities, expectations, assumpand

society when exploring alternatives. tions, incentives, and consequences for this

problem from different perspectives, including:

● The team member who is late

● Other team members

● The team’s client

Clarify and apply ethical values when choosing Draft a policy statement that you could adopt

a course of action. with future team members to handle project

delays. How might this policy lead to improved

team performance?

Work toward ongoing improvement of personal Think about your future career. How can you

and organizational ethics. work toward developing your professional responsibility

as a member of a work team?

10These elements

■ **Long-Term Versus Short-Term Incentives**

For many years, U.S. compensation practices were criticized because they were based on accounting

earnings. In addition to the problems already described, managers could also reduce

the level of investment in assets such as equipment, thereby reducing depreciation expense

and, in turn, increasing accounting earnings. However, the reduced investment

negatively affects future earnings if sales are forgone because of either limited capacity or

increases in maintenance and downtime costs for old equipment that should have been

9P. Kennedy “Redefining Compensation in Challenging Times,” *Employee Benefits Journal,* September 2003, p. 63.

10J. Novack, “The Do-It-Yourself Billionaire,” *Forbes.com,* October 6, 2003.

11J. Lublin, “Executive Pay Keeps Rising, Despite Outcry,” *The Wall Street Journal,* October 3, 2003, p. B1.

12L. Yoon, “Former CFO Now CEO at American Airlines, Union Leader Praises Arpey Appointment. Will Creditors,

Shareholders Feel the Same Way?” *CFO.com,* April 28, 2003.

**CURRENT PRACTICE**

Soon after **American Airlines**

employees accepted major cutbacks

in salaries to prevent bankruptcy,

news was released that top managers

received bonuses in the form of large

contributions to their pension

plans.12

replaced. In addition, manufacturers sometimes increase revenues by forcing their customers

to carry large inventories. These types of actions may increase short-term earnings, but often

have negative effects on long-term earnings potential.

To focus managers more on the long term, many companies in the United States increased

the use of stock-based compensation. Stock options, in particular, became popular

during the 1980s and 1990s. Compensation tied to the value of stock was viewed as a way

to encourage managers and other employees to focus on increasing the long-term value of

the company. However, company stock prices are sensitive to changes in earnings. Some

managers engaged in unethical or illegal activities to boost reported income so that stock

prices would remain stable or increase. Earnings manipulation was a significant problem during

the early 2000s; many large U.S. corporations and their accounting firms came under

scrutiny from the **Securities Exchange Commission**.

■ **International Compensation**

In the past, compensation practices outside of the United States often focused on factors other

than stock price. In France and Germany, for example, CEO and top management rewards

were sometimes tied to the average salary of all employees because the board of directors

included labor union representation. These types of contracts provide incentives to increase

the wages of all employees. However, in the early 2000s European companies, which were

struggling to attract and retain highly skilled and talented people, began using stock options

for top and mid-level managers.

For example, a new law was passed in Germany in 1998, making it easier for companies

to use stock options. About 50% of companies listed in Frankfurt’s DAX 100 stock index

now have stock option plans. European companies tend to link the options to specific

performance hurdles, such as increases in share price relative to competitors. Recently, shareholders

in Europe have begun to actively examine top executives’ compensation packages.

Shareholders in the United Kingdom have criticized several large companies, including

telecommunications giant **Vodafone Group** and insurer **Prudential** for paying excessive executive

compensation, or even for considering executive pay packages perceived as being

too large.13

Some countries still discourage options. In Belgium and Switzerland, managers are required

to pay taxes on the potential gain at the time stock options are granted. If stock prices

fall, managers are not allowed to receive a refund of taxes previously paid. In France the

capital gains tax rate is 50%, greatly reducing the value of stock options.15

**MOTIVATING PERFORMANCE WITH COMPENSATION 605**

**INTERNATIONAL**

According to *Forbes,* the most

detailed information about executive

pay and benefits during 2002 was

provided by U.K. and Scandinavian

companies. Asian companies

provided little or no information

about executive pay.14

13D. Bilefsky, “Mad about Money,” *The Wall Street Journal,* April 14, 2003, p. R3.

14S. Kitchens, “The Top of the Heap,” *Forbes.com,* September 2, 2002.

15D. Woodruff, “Europe, a Latecomer, Embraces Options,” *The Wall Street Journal,* May 15, 2001, p. A18; and D.

Bilefsky, “Mad about Money,” *The Wall Street Journal,* April 14, 2003, p. R3.

The **New York Stock Exchange (NYSE)** is a not-for-profit corporation that operates a board of

exchange. The NYSE is owned by more than 1,300 members (memberships are often referred

to as “seats”) and is managed by corporate officers and a board of directors. The NYSE is a

private organization that assumes responsibility for regulating the activities on its exchange.

It is also subject to federal regulation by the Securities and Exchange Commission (SEC).

During March 2004, as many as 65 former members of the NYSE board of directors received

subpoenas from the SEC. The former directors were expected to provide details about how

they established pay for former NYSE chairman Richard (Dick) Grasso (Associated Press, 2004).

*(continued)*

**FOCUS ON ETHICAL DECISION MAKING**

**Level of Executive Pay**

**606 CHAPTER 15** ➤ **PERFORMANCE EVALUATION AND COMPENSATION**

Two months earlier, the SEC announced a formal investigation into whether the NYSE’s compensation

process for Grasso had violated any laws or NYSE rules (SEC, 2004).

Controversy over Dick Grasso’s pay began during August 2003, when the NYSE for the first

time ever publicly released information about the pay of its top executives. Grasso’s annual pay

was disclosed to include $1.4 million in salary plus a nonguaranteed bonus of approximately

$1 million. Nonsalary compensation for the preceding four years had ranged from $9.9 million to

$24.2 million per year (McCall, 2003). Grasso received a 2003 payout of approximately $140 million

through withdrawals from a retirement plan, a savings plan, and prior bonus awards. The

$140 million was characterized in the news media as “outlandish,” “excessive,” “outsized,” and

“unseemly.” The disclosures caused a public outcry, followed by Grasso’s resignation in September

2003 (Weiss, 2003; Weiss et al., 2003).

Considerable disagreement arose about whether the level of pay was too high. Arguments in

support of Grasso’s pay included the following (Weiss, 2003; McCall, 2003):

● Positive NYSE performance during Grasso’s tenure:

—NYSE seat prices tripled.

—NYSE invested $2 billion in technology and trading upgrades.

—NYSE handled record volumes and maintained business in the face of increased competition.

—Grasso was viewed as a good manager.

● NYSE’s use of compensation consultants and a separate board of directors’ compensation

committee to help set the pay levels.

● Comparability of Grasso’s pay to that of public company executives.

● NYSE goal to “attract and retain superior ‘world class’ executives” (McCall, p. 2).

● Reasonableness of $140 million in light of Grasso’s long tenure at NYSE; he had been hired

as a clerk in 1968, rose to president in 1988, and became chairman in 1994.

Arguments against Grasso’s pay included the following (Weiss, 2003; Parker et al., 2004; Associated

Press, 2004):

● Concerns that NYSE board of directors was not sufficiently independent and exercised poor

governance.

● Claims that the NYSE board of directors was “hand-picked” by Grasso and that the compensation

committee was headed by a close Grasso friend.

● Charges that under Grasso the NYSE had not adequately regulated floor traders or member

firms.

● Comparison of Grasso’s pay to that of regulators such as SEC chairman William Donaldson,

who earned about $140,000 per year.

● Findings from an internal NYSE investigation that reportedly concluded Grasso had been cumulatively

overpaid $100 million in pension accounts and $40 million in deferred compensation.

● The uncommon nature of lump-sum withdrawals from pension and savings plans.

Some observers, such as financial author Roger Lowenstein, pointed out that it is not clear

how to determine an appropriate level of pay for executives. However, he also argued that the

board of directors serves as an agent on behalf of NYSE members. Board members who lack independence

may be unable to design compensation packages that adequately reflect free-market

incentives (Lowenstein, 2003). In the NYSE case, the SEC stated that the approval of Grasso’s pay

package “raised serious questions regarding the effectiveness of NYSE’s current governance structure”

(SEC, 2004).

SOURCES: Associated Press, “Ex-NYSE Directors Subpoenaed,” MSNBC, March 5, 2004, available at

www.msnbc.msn.com/id/4455963; “SEC Authorizes Formal Investigation of Matters Raised in Webb Report,” press

release 2004-3, Securities and Exchange Commission, January 8, 2004; G. Weiss, P. Dwyer, and M. Der Hovanesian,

“Big Changes for the Big Board,” *BusinessWeek online,* September 29, 2003; G. Weiss, “The $140,000,000 Man,”

*BusinessWeek online,* September 15, 2003; H. Carl McCall, Chairman, NYSE Human Resources and Compensation

Committee, letter to William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, September 9,

2003, available at www.nyse.com/pdfs/donaldsonletter.pdf; J. Parker, C. P. Gallagher, and J. Landry, “Former NYSE

Chair Richard Grasso’s Pay Included $8.4 Million Pension, Reports *Fortune* Magazine,” press release, *Fortune.com,*

February 2, 2004; and R. Lowenstein, “Excess Unlimited: Can Corporate America Curb the Monster?” *Washington-*

*Post.com,* October 12, 2003, p. B01.

**Practice Ethical Decision Making**

In Chapter 1, we learned about a process for making ethical decisions (Exhibit 1.11). You can address

the following questions for this ethical dilemma to improve your skills for making ethical

decisions. Think about your answers to these questions and discuss them with others.

**Questions to Consider**

**Ethical Decision-Making Process about This Ethical Dilemma**

Identify ethical problems as they arise. Is the level of executive pay an ethical issue

for boards of directors? Why or why not? Why

is it impossible to determine with certainty

what Grasso’s pay should have been?

Objectively consider the well-being of others From the viewpoint of a member of the board

and society when exploring alternatives. of directors, discuss the pros and cons of

Grasso’s $140 million payout. Consider the effects

on stakeholders such as:

● Other NYSE employees

● Shareholders (NYSE members)

● Competitors (other stock exchanges)

● Companies listed on the NYSE

● External auditors

● Regulators such as the SEC

● Society

Clarify and apply ethical values when choosing What should the NYSE board of directors do to

a course of action. achieve better corporate governance over executive

pay? Clarify the values you use in

drawing your conclusions.

Work toward ongoing improvement of personal It is possible to argue that the NYSE board of

and organizational ethics. directors failed to recognize a change from the

“old days” when high executive pay was acceptable,

to a new environment in which executive

pay must be justified. How can a board

of directors continuously reevaluate and improve

its approach to issues such as this one?

**TRANSFER PRICE POLICIES 607**

When one unit relies on other units within an organization for goods or services, a problem

arises that affects the measurement of financial performance. Suppose Porcelain & More, a

kitchen and bath fixtures manufacturer, operates with three profit centers: fixtures, sinks, and

tubs. Sinks and tubs are sold as kits that include fixtures. In their kits, the sink and tub profit

centers use the faucets and handles produced by the fixture profit center. Thus, these fixtures

are transferred from one department to the other two departments, and the fixtures need to be

priced appropriately. A **transfer price** is the price used to record revenue and cost when goods

or services are transferred between responsibility centers in an organization.