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Bachelor of Commerce (B2001) | Level 3 • Part B Major | Monash University

Management accounting

Course Code: ACC3200 • Module 3 Notes

Module 3: Balanced Scorecard, Strategy Maps, Non-Financial KPIs & Incentive Compensation

3.1 Limitations of Purely Financial Performance Measurement

For decades, corporate performance evaluation relied almost exclusively on accounting metrics—net profit after tax, earnings per share (EPS), budget variances, and return on investment (ROI). While financial outcomes remain the ultimate scorecard of shareholder wealth creation, relying solely on accounting profit for managerial planning and control creates severe informational and behavioural distortions in modern knowledge-based and service-oriented economies.

First, financial statements are **lagging indicators**: they summarise the monetary consequences of decisions taken months or years earlier. A decline in quarterly EBIT frequently signals that customer satisfaction, product reliability, or employee capability deteriorated long before sales dropped, leaving management reacting too late. Second, historical-cost financial accounting systematically omits **intangible value drivers**—brand equity, customer loyalty, proprietary software, employee engagement, and operational safety—because accounting standards such as AASB 138 (*Intangible Assets*) prohibit capitalising internally generated brands, customer lists, and research outlays. Third, excessive pressure to hit short-term profit targets induces **managerial myopia**: executives can artificially inflate current-year profit by slashing preventive maintenance, deferring staff training, or cutting R&D, thereby harvesting short-term bonuses while eroding long-term competitiveness. Finally, single-minded reliance on accounting profit invites **accrual manipulation and real earnings management**, such as channel stuffing near financial year-end on 30 June to pull forward revenue.

Performance Dimension	Purely Financial Control System	Integrated Balanced Performance System
Temporal Orientation	Backward-looking; measures historical transaction outcomes over a single fiscal year.	Forward-looking and balanced; links leading operational drivers to lagging financial returns.
Asset Recognition	Recognises tangible capital and purchased goodwill; expenses internal capability building.	Tracks human capital, information systems, customer retention, and process quality explicitly.
Behavioural Risk	Encourages myopic cost cutting, maintenance deferral, and channel stuffing.	Counters short-termism via multi-perspective metrics and deferred/risk-adjusted incentives.
Strategic Linkage	Disconnected from day-to-day operational choices of frontline teams.	Translates corporate strategy into actionable operational KPIs across every business unit.

3.2 The Balanced Scorecard (BSC) Framework

Introduced by Robert Kaplan and David Norton in 1992 and refined into a comprehensive strategic management system, the **Balanced Scorecard (BSC)** supplements traditional financial measures with operational and strategic metrics organised across four interconnected perspectives: Financial, Customer, Internal Business Process, and Learning and Growth. The term "balanced" signifies equilibrium across four critical dimensions: (1) short-term versus long-term objectives, (2) financial versus non-financial indicators, (3) lagging outcome measures versus leading performance drivers, and (4) internal operational metrics versus external market perceptions.

3.2.1 The Four Balanced Scorecard Perspectives

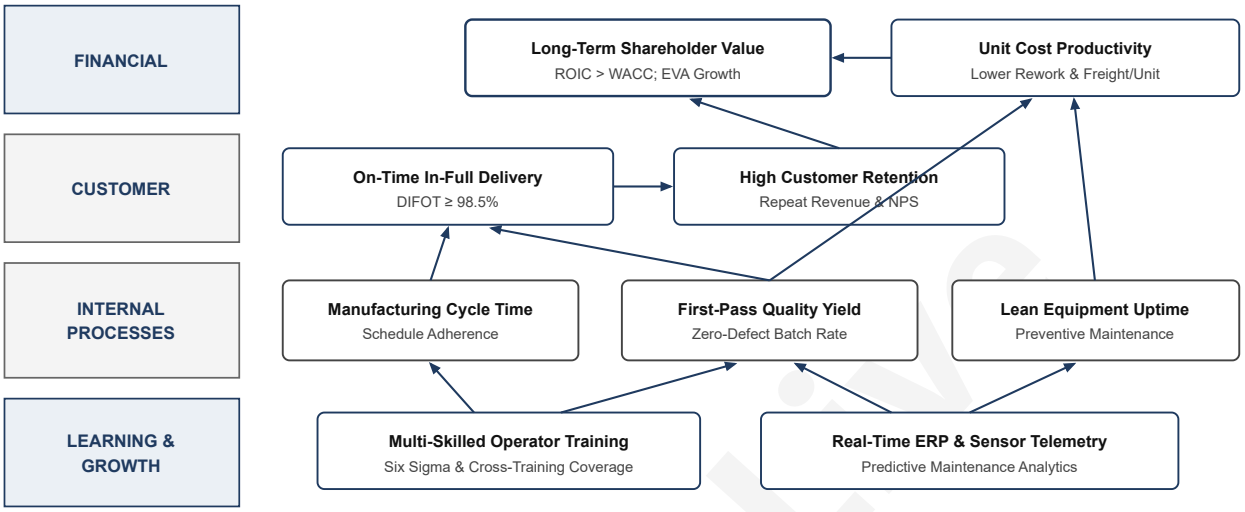
1. **Financial Perspective ("How do we look to shareholders?"):** Captures the ultimate economic objectives of the enterprise—revenue growth, cost productivity, asset utilisation, and shareholder return (EVA, ROIC, free cash flow, operating margin). Financial objectives vary with the business unit's strategic life-cycle stage: *growth* units prioritise sales expansion and capital deployment, *sustain* units emphasise ROCE and operating margin, and *harvest* units focus on cash generation and working capital release.
2. **Customer Perspective ("How do customers see us?"):** Identifies the target customer segments and the specific value proposition required to attract and retain them. Core lagging measures include market share, customer acquisition rate, customer retention rate, customer satisfaction (CSAT / Net Promoter Score), and customer profitability (linked to Module 1 CPA). Leading value-proposition drivers measure product attributes (quality, timeliness, functionality), customer relationships (response time, convenience), and brand reputation.
3. **Internal Business Process Perspective ("What processes must we excel at?"):** Pinpoints the critical internal workflows that deliver the customer value proposition and satisfy shareholder efficiency targets. Kaplan and Norton classify internal processes into four clusters: *operations management* (supply chain cycle time, defect rates, unit conversion cost), *customer management* (order fulfilment accuracy, complaint resolution speed), *innovation processes* (R&D pipeline velocity, time-to-market for new products), and *regulatory and social processes* (workplace health and safety LTIFR, environmental compliance).
4. **Learning and Growth Perspective ("How will we sustain our ability to change and improve?"):** Establishes the foundational intangible assets required to execute internal processes effectively over time. It encompasses three pillars: *human capital* (strategic job coverage, technical training hours, retention of key talent), *information capital* (ERP/analytics availability, cybersecurity resilience, real-time data coverage), and *organisational capital* (corporate culture, leadership alignment, teamwork, and knowledge sharing).

BSC Perspective	Strategic Objective (Australian Retail Bank Example)	Lagging Outcome Indicator	Leading Performance Driver
Financial	Grow sustainable risk-adjusted return on equity and diversify fee income.	Return on Equity (ROE), Cost-to-Income Ratio, Economic Profit.	Cross-sell product ratio per active household; digital transaction share.
Customer	Become the primary trusted digital and mortgage partner for metropolitan households.	Net Promoter Score (NPS), Annual Customer Retention Rate (%).	Mobile app uptime (%); average mortgage approval turnaround (days).
Internal Process	Automate credit underwriting and maintain strict APRA risk/conduct compliance.	Straight-through digital loan processing rate (%); credit loss rate.	Automated KYC verification speed; internal compliance audit pass rate.
Learning & Growth	Build data-engineering capability and embed ethical conduct culture.	Staff engagement index; retention of senior risk/data analysts.	Hours of ethical conduct & AML training; cloud analytics platform adoption (%).

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3.3 Strategy Maps and Cause-and-Effect Linkages

A frequent implementation failure occurs when organisations merely group 20 to 25 ad-hoc key performance indicators (KPIs) into four categories without articulating how they connect—producing a "dashboard of silos" rather than a strategic system. A **Strategy Map** resolves this weakness by visually mapping the explicit **cause-and-effect hypotheses** linking intangible Learning and Growth investments at the base upward through Internal Processes and Customer value propositions to Financial outcomes at the summit.



3.3.1 Validating Causal Linkages Empirically

Every link in a strategy map represents a falsifiable hypothesis of the form: *"If we invest in employee analytics training (Learning & Growth), then equipment downtime falls and first-pass yield rises (Internal Process); if first-pass yield rises, then Delivery In Full On Time (DIFOT) improves (Customer); if DIFOT improves, then repeat orders and ROIC increase (Financial)."* Management accountants play a critical role in empirically testing these assumed linkages using longitudinal regression or time-lagged correlation analysis across branches or stores. If empirical testing shows that higher customer satisfaction scores fail to produce higher store margins—for example, because staff achieve high satisfaction solely by granting excessive unauthorised discounts—the scorecard design is flawed and must be recalibrated.

3.3.2 Tailoring Strategy Maps to Competitive Value Propositions

Because different Australian enterprises pursue distinct competitive strategies, a strategy map cannot be copied from a generic template. Treacy and Wiersema's value-discipline taxonomy identifies three primary strategic themes that reshape the Customer and Internal Process layers of a strategy map:

Strategic Theme	Customer Value Proposition Focus	Critical Internal Process & Learning Priorities
Operational Excellence (Low Total Cost)	Competitive everyday pricing, zero defects, fast checkout/delivery, high reliability (e.g., national discount hardware or supermarket chains).	Supply chain automation, supplier TCO reduction, inventory turnover, asset utilisation, standardised store operating procedures.
Customer Intimacy (Tailored Solutions)	Personalised advisory service, account retention, share-of-wallet, solutions bundling (e.g., private wealth management or B2B logistics).	CRM analytics integration, cross-functional account teams, customer profitability (CPA) segmentation, consultative sales training.

Strategic Theme	Customer Value Proposition Focus	Critical Internal Process & Learning Priorities
Product Leadership (Innovation)	First-to-market functionality, superior engineering performance, premium price realisation (e.g., Australian med-tech or enterprise SaaS).	R&D stage-gate velocity, patent generation, rapid prototyping, percentage of revenue from products launched in past 3 years.

In not-for-profit and public-sector Australian organisations—such as Melbourne metropolitan public hospital networks or state transport agencies—the Strategy Map architecture adapts by placing *Fiduciary / Budget Stewardship* and *Citizen / Patient Outcomes* side by side at the apex, rather than shareholder profit. Financial metrics operate as an enabling constraint (operating within state Treasury funding appropriations and reducing cost per weighted episode of care) while the ultimate mission metrics capture clinical safety, emergency triage waiting times, and equitable service access.

3.4 Designing Non-Financial KPIs and Weighted Performance Scorecards

Selecting and weighting non-financial KPIs requires rigorous engineering to ensure validity, reliability, and resistance to manipulation. Effective operational KPIs exhibit five design attributes:

- **Strategic Alignment:** Every metric traces directly to an objective on the business unit's strategy map, avoiding generic metrics that distract managerial attention.
- **Controllability and Precision:** Metrics respond sensitively to managerial effort with minimal random external noise.
- **Timeliness and Auditable Data Integrity:** Indicators can be measured reliably at low cost and verified independently (e.g., automated POS timestamps or ERP logs rather than self-reported manager estimates).
- **Parsimony:** Restricting a business unit scorecard to roughly 12 to 20 high-impact metrics (3 to 5 per perspective) prevents cognitive overload and diffusion of focus.
- **Balanced Weighting:** Assigning explicit percentage weights prevents managers from chasing easy secondary metrics while neglecting core financial or safety thresholds.

3.4.1 Weighted Scorecard Index Formula and Worked AUD Example

When translating multi-perspective BSC outcomes into an annual Short-Term Incentive (STI) bonus pool, organisations typically calculate a **Weighted Scorecard Performance Score**:

$$S_{\text{total}} = \sum_{k=1}^{m} w_k \times \text{Score}_k \qquad \text{where} \quad \sum_{k=1}^{m} w_k = 1.00$$

For metrics where higher values represent better performance ("more is better," such as EBIT or DIFOT), linear interpolation between threshold and stretch targets is often bounded between 0% and 150%:

$$\text{Score}_k = \text{clip}\left(\frac{A_k - T_k}{B_k - T_k} \times 100\%,\ 0\%,\ 150\%\right)$$

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Where:

- S_{total} = Overall Weighted Balanced Scorecard Achievement Percentage.
- w_k = Strategic weight assigned to KPI k (summing to 1.00, or 100%).
- Score_k = Performance score achieved on KPI k, expressed as a percentage of target (100% at Target B_k).
- A_k = Actual observed result for KPI k.
- T_k = Minimum threshold ("baseline") below which payout is 0% (or scaled linearly from a threshold payout floor).
- B_k = Target benchmark (100% achievement).

Note on "Lower is Better" Metrics: For inverse indicators such as Lost Time Injury Frequency Rate (LTIFR) or defect rate, the numerator reverses to $(T_k - A_k)/(T_k - B_k)$ so improvements below threshold earn positive credit. Additionally, safety or risk-compliance gates (*hurdle modifiers*) can reduce overall payout to zero if a fatal workplace incident or major regulatory breach occurs.

Worked AUD Example (Divisional Manager Scorecard & Bonus Calculation): The General Manager of Murray Packaging Pty Ltd (Sydney) has a base salary of $280,000 and a Target STI bonus equal to 40% of base salary ($112,000 at $S_{\text{total}} = 100\%$). For FY2026, the Board establishes five weighted KPIs across the four BSC perspectives, using a simplified linear achievement formula $\text{Score}_k = \frac{A_k}{B_k} \times 100\%$ for "higher is better" metrics (and $\frac{B_k}{A_k} \times 100\%$ for inverse safety/defect metrics), capped at 130% per KPI, subject to a zero-fatality gateway:

BSC Perspective	KPI	Weight (w_k)	Target (B_k)	Actual (A_k)	Raw Achievement	Capped Score	Weighted Contribution
Financial	Divisional EVA	40%	$4,000,000	$4,480,000	112.0%	112.0%	44.80%
Customer	DIFOT Delivery (%)	20%	96.0%	97.92%	102.0%	102.0%	20.40%
Internal Process	Scrap & Defect Rate (%) ↓	15%	2.0%	1.60%	125.0%	125.0%	18.75%
Internal Process	Safety LTIFR (per million hrs) ↓	15%	4.0	5.0	80.0%	80.0%	12.00%
Learning & Growth	Operator Certification (%)	10%	90.0%	81.0%	90.0%	90.0%	9.00%
Total	—	**100%**	—	—	—	—	**104.95%**

Step-by-Step Bonus Resolution:

1. **Weighted Scorecard Score (S_{total}):** 44.80% + 20.40% + 18.75% + 12.00% + 9.00% = **104.95%**.
2. **Gross STI Bonus Earned:** $\text{Target STI} \times S_{\text{total}}$ = $112,000 × 1.0495 = **$117,544**.

3. **Diagnostic Insight:** Although strong EVA (+12%) and reduced scrap boosted overall score to 104.95%, the safety LTIFR deterioration (5.0 vs target 4.0) and lagged operator training (81% vs 90%) signal rising operational risk that could trigger future rework or regulatory intervention by SafeWork NSW. Under an APRA-style or board risk modifier, the Remuneration Committee might exercise downward discretion on the safety component until corrective training is completed.

3.4.2 Target Setting, Ratcheting, and Relative Performance Evaluation

Determining the benchmark target (B_k) for each scorecard metric is frequently more contentious than selecting the metric itself. Organisations draw targets from three primary sources: (1) *historical internal performance* (prior-year actuals plus a continuous-improvement increment), (2) *internal negotiated budgets*, and (3) *external competitive benchmarks* (peer ASX quartiles or industry standards). Relying purely on historical internal actuals creates the **ratchet effect**, whereby superior performance this year permanently elevates next year's baseline hurdle, penalising high-performing managers. Conversely, relying solely on bottom-up negotiated budgets invites **budgetary slack**, as divisional managers privately suppress forecast sales or pad expense estimates to secure easily achievable bonus thresholds.

To counteract both biases, management accountants deploy **Relative Performance Evaluation (RPE)** alongside structured target negotiation. Under RPE, a business unit's financial or operational achievement is benchmarked against a peer group exposed to similar external demand or input-price shocks (for example, comparing a Queensland retail branch's same-store sales growth against the state retail index or peer regional stores). Filtering out common industry shocks isolates controllable managerial effort, lowers the uncontrollable variance σ^2 borne by risk-averse managers, and preserves incentive alignment during unexpected booms or downturns.

3.4.3 Worked AUD Example: Long-Term Incentive (LTI) Relative TSR Vesting

Beyond annual STI scorecards, senior Australian executives receive Long-Term Incentives (LTI) structured as zero-exercise-price **Performance Rights** tested over a 3-year vesting period. Suppose the Chief Financial Officer of Tasman Logistics Ltd (ASX-listed) is granted 80,000 Performance Rights at a grant-date share price of $7.50 (face value $600,000). Vesting is governed equally by two independent hurdles: 50% (40,000 rights) on 3-year **Relative Total Shareholder Return (rTSR)** against the S&P/ASX 200 Industrials peer group, and 50% (40,000 rights) on 3-year average **Return on Invested Capital (ROIC)**:

- **rTSR Vesting Schedule:** Below 50th percentile = 0% vests; at 50th percentile (threshold) = 50% vests; between 50th and 75th percentile = straight-line pro-rata vesting from 50% to 100%; at or above 75th percentile = 100% vests.
- **ROIC Vesting Schedule:** Below 11.0% (WACC) = 0% vests; at 11.0% = 50% vests; straight-line pro-rata up to 14.0% = 100% vests.

Three-Year Outcome Resolution: At the end of Year 3, Tasman Logistics achieves an rTSR ranking at the 65th percentile of the ASX 200 Industrials peer group and a 3-year average ROIC of 12.8%, while its share price rises to $9.20:

1. **rTSR Tranche (40,000 rights):** Percentile rank of 65% sits 15 / 25 = 60% of the way between the 50th and 75th percentiles. Vesting percentage = 50% + 0.60 × (100% − 50%) = 80.0%. Vested rights = 40,000 × 80.0% = **32,000 shares**.
2. **ROIC Tranche (40,000 rights):** Average ROIC of 12.8% sits $(12.8\% - 11.0\%)/(14.0\% - 11.0\%) = 1.8\%/3.0\% = 60\%$ of the way between 11.0% and 14.0%. Vesting percentage = 50% + 0.60 × (100% − 50%) = 80.0%. Vested rights = 40,000 × 80.0% = **32,000 shares**.

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3. **Total Vested Value:** 64,000 shares × $9.20 = **$588,800** (with 16,000 unvested rights lapsing immediately). Pairing rTSR (which filters out general ASX market rallies) with ROIC (which prevents value-destructive debt-funded acquisitions that inflate EPS) provides balanced multi-year capital discipline.

3.5 Incentive Compensation, Agency Theory, and Australian Governance

Performance measurement systems acquire motivational force only when linked to tangible rewards and accountability. Designing executive and managerial compensation contracts sits at the intersection of economic agency theory, organisational psychology, and Australian corporate law.

3.5.1 Principal-Agent Theory and Contract Design

In publicly listed corporations, shareholders (the **principals**) delegate operational control to hired executives and divisional managers (the **agents**). Agency conflicts emerge from two simultaneous conditions: (1) *divergent preferences*—agents value personal leisure, job security, perquisites, and lower risk, whereas diversified shareholders seek risk-adjusted net present value—and (2) *information asymmetry*, comprising **adverse selection** (hidden private information before hiring/contracting, such as a manager understating divisional capacity during budget setting to create budgetary slack) and **moral hazard** (hidden unobservable effort after contracting).

Incentive contracts typically combine a fixed base salary with variable pay tied to observable performance signals:

$$W = \alpha + \beta \cdot P \qquad \text{where} \quad P = e + \varepsilon, \quad \varepsilon \sim N(0, \sigma^2)$$

Where:

- W = Total managerial compensation in Australian dollars.
- α = Fixed base salary independent of short-term performance outcomes.
- β = Incentive intensity (piece-rate or bonus slope parameter, $0 \le \beta \le 1$, linking pay to measured performance).
- P = Observed performance metric (e.g., divisional EVA or balanced scorecard index).
- e = Unobservable managerial effort (productive action).
- ε = Random uncontrollable environmental noise with zero mean and variance σ^2 (e.g., macroeconomic cycles, weather events, exchange rate swings).

This linear agency model highlights a fundamental **effort-incentive versus risk-sharing trade-off**. Raising incentive intensity β motivates the agent to exert higher effort e, reducing moral hazard. However, because P contains uncontrollable noise ε, a higher β also exposes a risk-averse manager to income volatility. To accept greater pay risk, a risk-averse manager demands a higher expected total compensation (a *risk premium*). Consequently, the optimal incentive intensity β^* declines as environmental uncertainty σ^2 rises or as the agent's risk aversion increases, and rises as the marginal productivity of managerial effort increases or as better metrics reduce noise σ^2 (known as **Holmstrom's Informativeness Principle**: any additional performance indicator that reduces measurement error about managerial effort—such as peer-relative benchmarking—should be included in the contract).

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Worked AUD Numerical Example (Risk-Sharing vs Incentive Intensity): Consider a Melbourne fintech division evaluating two contract structures for a risk-averse manager whose utility is represented by certainty equivalent $CE = E[W] - \frac{1}{2}r \cdot \text{Var}(W) - C(e)$, where risk-aversion coefficient $r = 0.00001$, effort cost in expected dollar value generated is $C(e) = \frac{e^2}{500{,}000}$, and random market noise has standard deviation σ = \$100,000 ($\sigma^2 = 10^{10}$). Under a pure fixed salary ($\beta = 0$, α = \$200,000), the manager exerts zero discretionary effort ($e = 0$) and faces zero pay risk ($\text{Var}(W) = 0$), yielding CE = \$200,000 and zero incremental profit above base pay. Under a variable incentive contract with $\beta = 0.40$, the manager chooses effort where marginal private benefit β equals marginal effort cost $C'(e) = \frac{e}{250{,}000}$, yielding optimal effort e^* = 0.40 × 250,000 = **\$100,000** in incremental divisional profit. Effort cost is $C(e^*) = \frac{100{,}000^2}{500{,}000}$ = \$20,000, and pay variance is $\text{Var}(W) = \beta^2\sigma^2 = 0.16 \times 10^{10} = 1.6 \times 10^9$. With $r = 10^{-5}$, the risk premium penalty is $\frac{1}{2} \times 10^{-5} \times 1.6 \times 10^9$ = \$8,000. To match the manager's \$200,000 reservation certainty equivalent ($CE = \alpha + 0.40e^* - C(e^*) - \text{Risk Premium}$ = \$200,000), the firm sets fixed salary α = \$200,000 − \$40,000 + \$20,000 + \$8,000 = \$188,000. Expected total compensation is \$188,000 + \$40,000 = \$228,000 (\$28,000 above fixed pay) while generating \$100,000 in incremental gross profit—delivering a net corporate gain of **\$72,000**.

3.5.2 Short-Term Incentives (STI), Long-Term Incentives (LTI), and Australian Regulation

In ASX-listed Australian corporations, executive remuneration packages combine three structural layers:

Remuneration Element	Time Horizon & Instruments	Primary Strategic Purpose
Total Fixed Remuneration (TFR)	Annual cash base salary plus statutory Superannuation Guarantee contributions (11.5%–12%).	Attracts and retains executive talent at competitive market benchmarks without encouraging excessive risk-taking.
Short-Term Incentive (STI)	1-year performance period; cash bonus plus partial deferral (25%–50%) into restricted equity for 1–2 years.	Rewards annual delivery of budget profit, EVA, operational KPIs, customer service, and safety targets.
Long-Term Incentive (LTI)	3- to 5-year performance period; Performance Rights / share options vesting on Relative TSR, EPS growth, or ROIC hurdles.	Aligns senior executives with multi-year shareholder wealth creation and discourages short-term earnings manipulation.

Australia's corporate governance regime enforces rigorous statutory oversight over incentive design:

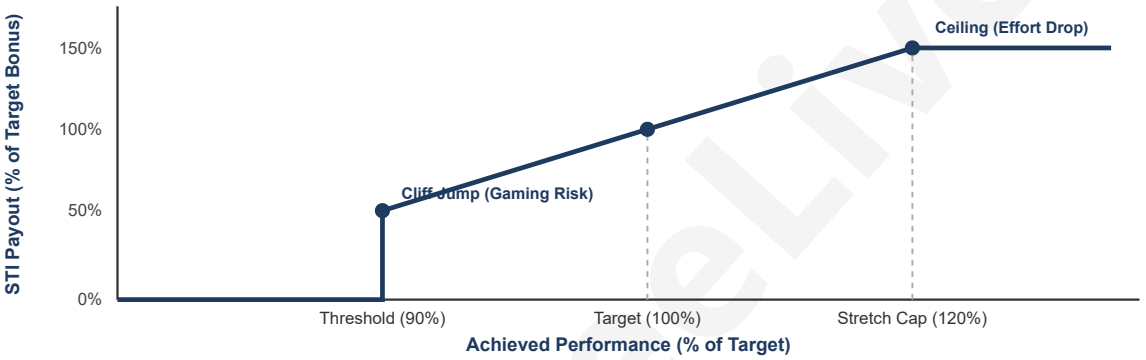
- **Corporations Act 2001 (Cth) — Section 300A & "Two-Strikes" Rule (ss. 250U–250V):** Listed disclosing entities must publish an audited Remuneration Report detailing the link between executive pay and corporate performance. At each Annual General Meeting (AGM), shareholders cast an advisory vote on the Remuneration Report. If 25% or more of votes cast oppose the report at two consecutive AGMs ("two strikes"), shareholders immediately vote on a "spill resolution" requiring all non-managing-director board members to stand for re-election within 90 days.
- **APRA Prudential Standard CPS 511 (Remuneration):** Effective across APRA-regulated banks, insurers, and superannuation trustees, CPS 511 mandates that variable remuneration cannot rely solely on financial metrics: *non-financial risk, customer conduct, and compliance measures must carry material weight*. Furthermore, CEOs and senior accountable executives at Significant Financial Institutions (SFIs) face mandatory minimum deferral periods of 4 to 6 years, accompanied by enforceable **malus** (forfeiture

of unvested deferred equity) and **clawback** (recovery of previously paid variable pay) clauses if misconduct or risk failures emerge later.

- **ASX Corporate Governance Council Principles (Principle 8):** Recommends independent Remuneration Committees composed primarily of independent non-executive directors to prevent executive self-dealing in target setting and discretionary overrides.

3.5.3 Non-Linear Bonus Schedules, Risk Gates, and ESG Weightings

Rather than paying strictly linear contracts across all outcomes, Australian corporate STI plans almost universally employ a **piecewise linear (threshold–target–cap) payout curve**. Below a minimum performance threshold (typically 85% or 90% of budget), zero bonus is paid; at threshold, a step jump (e.g., 50% of target bonus) often activates; between threshold and stretch cap (typically 120% of budget), bonus rises linearly up to a ceiling (e.g., 150% of target STI). While caps protect shareholders from paying windfall bonuses caused by unexpected commodity booms, step-cliffs and ceilings introduce non-linear behavioural distortions.



Under APRA CPS 511 and contemporary ASX 100 governance practice, boards increasingly embed explicit **risk and ESG modifiers** alongside the payout curve. For example, an Australian mining or energy executive's computed scorecard bonus may be multiplied by a risk-conduct modifier ranging from $0.0 to 1.10$, where a fatality, major environmental licence breach, or severe cybersecurity data failure triggers automatic downward adjustment regardless of financial profit. Similarly, embedding 15% to 25% of scorecard weight in measurable customer trust, workplace safety, and decarbonisation targets ensures non-financial stewardship carries direct pecuniary weight rather than merely advisory status.

3.6 Behavioural Consequences and Dysfunctional Responses to Measurement

Every performance measurement system shapes human attention and behaviour—often in unintended ways. As articulated by **Goodhart's Law** (*"When a measure becomes a target, it ceases to be a good measure"*) and **Campbell's Law** (*"The more any quantitative social indicator is used for social decision-making, the more subject it will be to corruption pressures"*), tying substantial financial rewards or career penalties to specific KPIs predictably triggers six dysfunctional behavioural responses:

1. **Gaming and Target Ratcheting Responses:** When targets are set using prior-year performance (the *ratchet effect*), managers deliberately withhold peak productivity once annual targets are met so headquarters does not raise next year's quota. Similarly, during participative budgeting, managers build *budgetary slack* by understating revenue potential and overstating expected costs.

2. **Data Manipulation and Smoothing:** Managers may shift revenues or expenses across accounting periods (e.g., delaying vendor invoice approvals past 30 June, reclassifying operating repairs as capital improvements, or altering inspection defect logs) to smooth volatility or clear bonus thresholds.
3. **Myopic Behaviour (Short-Termism):** Overweighting quarterly or annual financial metrics induces managers to defer maintenance, cut staff training, neglect equipment calibration, or postpone R&D—sacrificing long-term operational capability for immediate bonus payouts.
4. **Tunnel Vision (Measure Fixation):** Employees concentrate exclusively on measured KPIs while neglecting unmeasured but vital organisational dimensions. For instance, evaluating call-centre staff solely on "average call duration" encourages staff to hang up on complex customer queries prematurely, degrading actual customer resolution.
5. **Suboptimisation (Local Silo Maximisation):** Divisional managers optimise local unit metrics at the expense of peer divisions or enterprise goals—such as a sales team promising unrealistic custom delivery dates to boost monthly sales volume, causing costly overtime and rush freight in manufacturing and logistics.
6. **Kink-Induced Risk Distortion:** Step-function bonus plans ("cliff" payouts at 100% target, or caps at 120%) create extreme behavioural discontinuity. A manager sitting at 98% of target in mid-June faces an intense temptation to cut corners or manipulate accruals to cross the 100% cliff, whereas a manager sitting at 70% (well below threshold) or 125% (above cap) faces zero marginal incentive for additional effort and may "take a bath" by pulling future write-offs into the current losing year.

3.6.1 Organisational Safeguards Against Dysfunctional Behaviour

Management accountants mitigate these behavioural pathologies through four complementary institutional controls:

- **Balanced Multi-Measure Contracts:** Pairing short-term financial profitability with leading Balanced Scorecard metrics (quality, employee capability, customer retention, risk compliance) makes it significantly harder to fake performance across all dimensions simultaneously.
- **Relative Performance Evaluation (RPE) and External Benchmarking:** Evaluating business units against peer industry indices or comparable internal branches strips out common macroeconomic shocks (ε), reducing risk premiums and discouraging budget-slack lobbying.
- **Structured Subjectivity and Board Discretion:** Retaining well-documented ex-post discretion (as required under APRA CPS 511) allows Remuneration Committees to scale down bonuses when financial targets were achieved via excessive risk-taking, customer harm, or safety breaches—even if quantitative thresholds were technically met.
- **Long-Term Equity Deferral and Malus/Clawback:** Deferring 40% to 60% of executive incentives over multi-year horizons ensures that myopic actions (such as cutting maintenance or issuing reckless credit) backfire before deferred equity vests.

3.6.2 Truth-Inducing Budgeting and Worked AUD Example

When headquarters relies on divisional managers to submit profit forecasts during annual budgeting, conventional bonus formulas tied strictly to beating the self-selected budget create strong incentives to submit understated targets (budgetary slack). Truth-inducing incentive mechanisms—such as the **Weitzman linear-kink bonus scheme**—counteract slack by rewarding managers both for submitting higher initial targets and for exceeding them, while penalising shortfalls relative to the committed target:

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$$B = B_0 + \beta_1 \hat{\Pi} + \beta_2(\Pi - \hat{\Pi}) \quad \text{if } \Pi \geq \hat{\Pi}; \qquad B = B_0 + \beta_1 \hat{\Pi} - \beta_3(\hat{\Pi} - \Pi) \quad \text{if } \Pi < \hat{\Pi}$$

Where:

- B = Total annual bonus earned by the divisional manager in AUD.
- B_0 = Base target bonus anchor.
- $\hat{\Pi}$ = Profit target proposed (committed) by the divisional manager at the start of the year.
- Π = Actual realised divisional profit at year-end.
- $\beta_1, \beta_2, \beta_3$ = Incentive slope parameters calibrated such that 0 < *beta_2* < *beta_1* < *beta_3*.

Worked AUD Verification: Suppose a division manager knows privately that actual achievable profit will be Π = \$5,000,000. Corporate sets B_0 = \$20,000, $\beta_1 = 0.04$ (4% of committed target), $\beta_2 = 0.02$ (2% of upside beat), and $\beta_3 = 0.06$ (6% penalty on shortfall):

- **If manager builds \$1,000,000 of slack ($\hat{\Pi}$ = \$4,000,000):** B = \$20,000 + 0.04(\$4,000,000) + 0.02(\$5,000,000 − \$4,000,000) = \$20,000 + \$160,000 + \$20,000 = **\$200,000**.
- **If manager reports truthfully ($\hat{\Pi}$ = \$5,000,000):** B = \$20,000 + 0.04(\$5,000,000) + \$0 = **\$220,000**.
- **If manager over-promises aggressively ($\hat{\Pi}$ = \$6,000,000):** B = \$20,000 + 0.04(\$6,000,000) − 0.06(\$6,000,000 − \$5,000,000) = \$20,000 + \$240,000 − \$60,000 = **\$200,000**.

Because $\beta_2 < \beta_1 < \beta_3$, the manager maximises personal bonus (\$220,000) exclusively by revealing the truthful \$5,000,000 forecast to headquarters, improving capital allocation and group cash-flow planning without adversarial budget negotiations.

3.6.3 Participative Budgeting, Fairness Perceptions, and Trust

Beyond mathematical contract parameters, empirical management accounting research highlights the crucial behavioural role of **procedural and distributive justice**. When employees perceive scorecard targets as transparently derived, controllable, and applied consistently across divisions, intrinsic motivation and voluntary cooperation rise—reducing reliance on costly monitoring. Conversely, unilateral top-down target revisions mid-year ("moving the goalposts"), opaque discretionary deductions, or rewarding favoured business units despite missed KPIs destroys organisational trust and accelerates voluntary turnover among high-performing managers. Balanced performance management therefore requires technical rigour in metric engineering paired with credible, transparent governance communication.

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