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First Federal Savings (A)

Late in the third quarter of 1974, the board of directors of First Federal Savings requested that their president, Gene Rice, submit a recommendation on whether or not to grant branch managers a cash bonus that year. According to the company's Management by Objectives (MBO) system, the granting of yearly bonuses was contingent upon the attainment of specific corporate profit objectives, in addition to the individual manager's performance against preestablished MBO targets. Earnings in 1974 were targeted for a 15% increase over the 1973 profit of $7,800,000. This 15% growth objective was established late in 1973 when management fully expected that First Federal could continue compounding its growth at a rate of 15% to 20% per annum (see **Exhibit 1**). But the economic slowdown of 1974 hit the savings and loan industry particularly hard, with depositors withdrawing their savings to meet living expenses and taking advantage of the higher interest rates offered on short-term treasury bills. This reduction in savings made it difficult to grant mortgages which, in turn, constrained corporate profits.

Gene Rice clearly knew that the 1974 MBO goals and profit objectives would not be met (see **Exhibit 2**). He commented:

> We did a bad job of picking objectives for 1974. We had been lulled to sleep by a fantastic growth rate and a good economy. In 1974 the market went to hell, and our targeted 15% increase in profit before tax was not realistic. You know we base our bonus on the company meeting its profit objectives. In the past years we have been able to give handsome bonuses, and in return I expect a lot of our people. If our managers don't perform, then we are doing them a disservice by keeping them.

Rice considered the MBO system to be the cornerstone of management productivity and morale. He wondered if he should recommend a bonus to reward managers for their exceptional efforts even though the desired results had not been achieved. If he did give the bonus, what impact would it have on the future credibility of the MBO system? (See **Exhibit 3**.)

About First Federal Savings

First Federal Savings and Loan Association of Phoenix received its charter on November 1, 1934. In 1935 First Federal and the State Building and Loan Association initiated a merger. The merger was completed on February 2, 1938, and the surviving company, First Federal, recorded assets of $1,982,495 at the end of the year.

Stephen X. Doyle prepared this case under the supervision of Professor Jay W. Lorsch as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Management, recognizing the growth potential in the Arizona economy, initiated a program of branch expansion. The criteria established for opening a new branch were the potential economic growth in the area and the marketing advantages of offering convenient services to local residents. By the late 1960s First Federal was serving 10 cities located in four counties of Arizona. According to management, the development of these branches gave the company a unique, competitive advantage, since a branch opening, in nearly every instance, was the forerunner of the development of a local shopping center.

This planned expansion continued through the late 1960s and early 1970s. In 1973, First Federal became the twenty-fifth largest savings and loan association in the nation. Combined assets stood at $778,000,000 (see **Figure A**). By the end of 1974, First Federal planned to operate 27 branches and 5 subsidiaries specializing in management services to the real estate industry and thrift institutions.

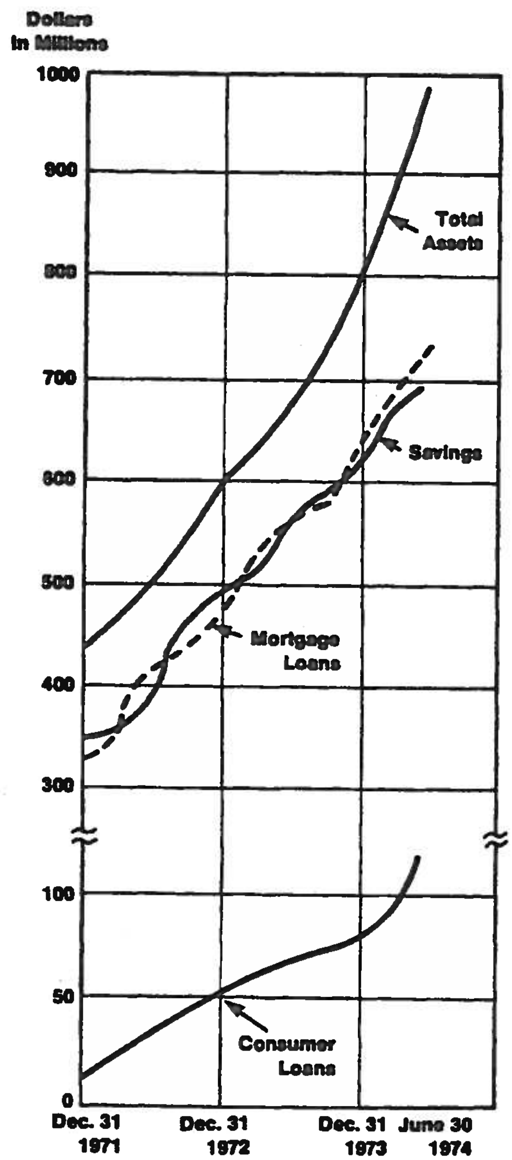
MBO and the Bonus Plan

In the eyes of top management, superior employee performance would be the key to accelerated corporate growth and profits. Both George Leonard, chairman of the board and chief executive officer, and Rice felt that if outstanding performances were to be expected, rewards of a sizable amount must be given at relatively frequent intervals. In 1968 a bonus program was introduced based on the amount of annual profits. The cost of the incentive plan was considered to be self-liquidating, because the bonus pool came from funds that were generated above and beyond the expected profit levels.

In 1968 a Management by Objectives system was also introduced. MBO was considered to be a cornerstone of the bonus plan because the MBO structure, with its clear and measurable goals, provided the opportunity to reward managers for results. Rice commented on the MBO and bonus systems:

> In the 1960s we were just an ordinary savings and loan association, but we wanted to be something more. We were in need of an entrepreneurial climate while ours was very much security- and image-conscious.
>
> The MBO system was instituted as a planning tool for the future and the changes it would bring. The bonus was added as a sidelight to "help make things happen!" We viewed the bonus program as a vehicle which could be used to recruit the entrepreneurs which the bank's more aggressive stance would require.

Figure A Recent Financial Trends



Source: Company records

The MBO process began late in the third quarter when the branch managers established financial and nonfinancial goals for the coming year. Each branch manager forwarded his or her goals to regional headquarters for approval. The regional manager and the branch manager often renegotiated projections before the final results were forwarded to corporate headquarters in Phoenix; there, all the branch and divisional goals were combined into an annual profit plan. The following MBO targets were typical at the branch-level office:

Financial Goals

1. Produce a net savings increase of x dollars
2. Produce a net increase in mortgage loans of x dollars
3. Produce a net increase in consumer loans of x dollars
4. Maintain sales, personnel, and office expenses within budgeted amounts

Nonfinancial Goals

1. Give one speech per month to community groups
2. Complete one course at a local college per semester
3. Serve on the board of a community service agency
4. Cross-train two employees per quarter

Rice expected each manager to be an outstanding example of First Federal in his area; he commented:

> The company has a commitment to Arizona and I expect our managers not only to run the best savings and loan in regard to profit but also to become involved in community service. In fact this commitment is specified in our nonfinancial targets. We don't just want a good looking branch office. I expect every manager to be a statesman in his community, to offer services and leadership just as George Leonard does on a national basis. Sure, it is expecting a lot, but our managers know that they will be rewarded for their performance.

Each month the local manager received individual feedback in the form of a computer report on his or her office's performance against monthly financial objectives. In addition, regional management was expected to interact with local branch managers about performance variances and the local manager's progress on nonfinancial objectives. Participators in the bonus plan were listed as follows (see **Figure B**):

1. Upper Management. Group

Chairman of the Board
President
Executive Vice President
President First Service Mortgage Corporation
Mortgage Loan Division Manager
Savings and Branch Operations Division Manager
Consumer Loan Division Manager Finance Division Manager
Data Processing Division Manager Vice President Personnel
House Counsel
Association Secretary
Regional Managers (3)

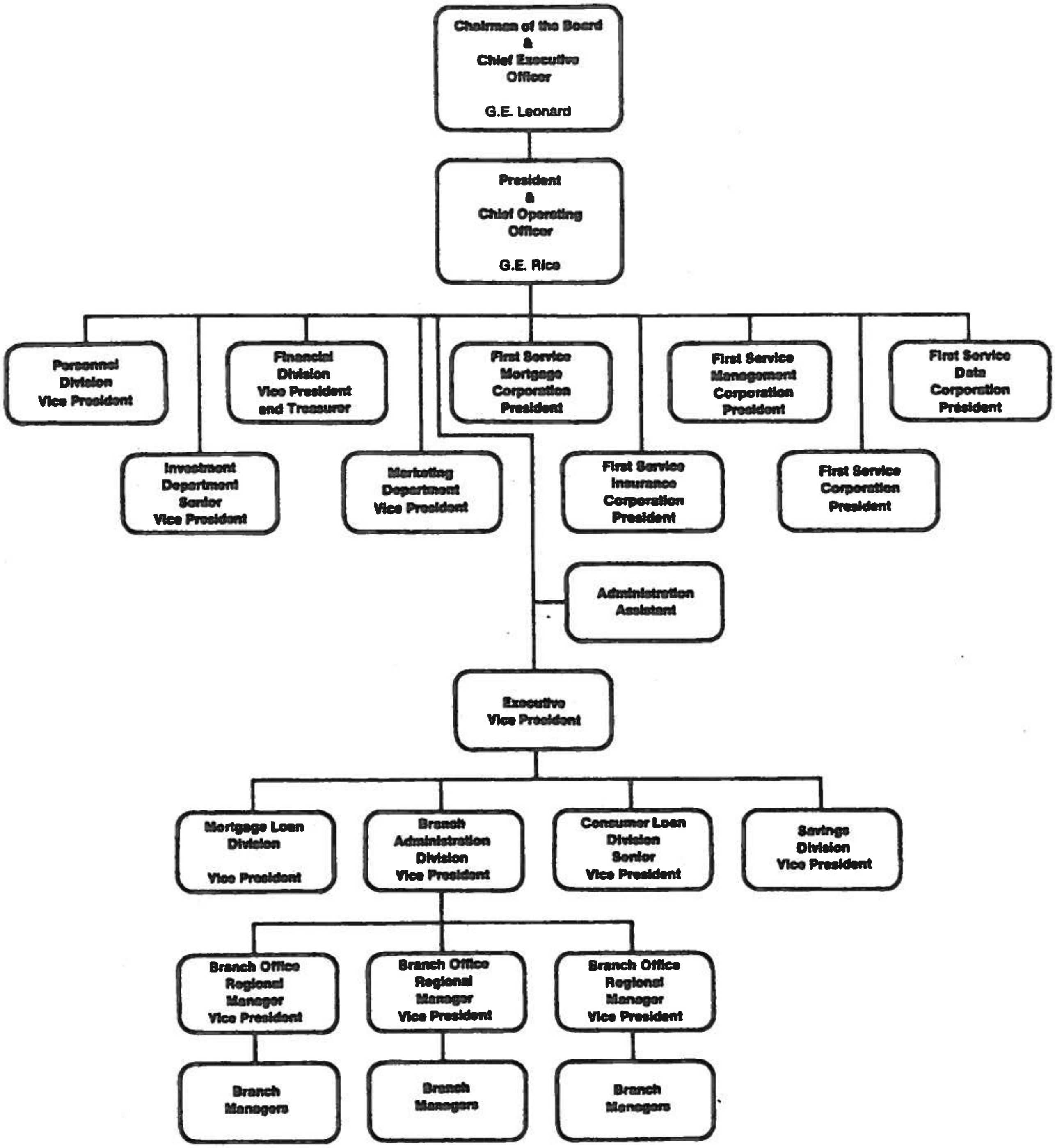
2. Department Heads and Specialist Group

Mortgage Loan Administration Manager
P.I. Production Manager
Accounting Department Manager
Assistant Data Processing Manager
Appraisal Department Manager
Loan Officers (2)
Systems and Procedures Manager
Mobile Home Loan Manager
Treasurer

3. Branch Manager Group

All Branch Managers

Figure B Organization Chart, 1974



Source: Company records

As previously stated, the amount of money available to the total bonus pool was based on profit generated above expected levels. The executive salary committee, based on First Federal's yearly forecasted profit plan, determined the profit levels that represented expected amounts, as well as the levels that represented superior performance beyond what was expected and thus deserved to be rewarded. According to this policy, a bonus would not be paid in 1974 unless 1974 profits exceeded 1973 profits by at least 15%.

The amount of the dollar reward to a manager was influenced by the individual's performance against objectives the manager had agreed to at the beginning of the year. The regional managers would review their subordinates and recommend a bonus amount for each of them. The actual determination of the bonus, however, was the prerogative of the executive salary committee. Generally speaking, the committee used the following guidelines to approve individual rewards:

1. The first 50% of the bonus pool should be allocated to an eligible employee based on his or her salary's percentage of the total salaries of all eligible employees in the incentive plan.
2. The second 50% of the bonus pool should be distributed with discretion by the committee.
3. No bonus should exceed 40% of an individual's base annual salary.

The Branch Managers

True to Rice's expectations, the branch managers were perceived by the casewriter to be talented, highly motivated "statesmen," who actively sought to increase the influence of First Federal in their respective areas. Typical of the managers under Rice was Harry Turner, who was in charge of the Scottsdale branch. After graduating from Arizona State University in 1966, Harry entered the Air Force's flight training school. In 1971, Harry resigned his commission and joined First Federal as a management trainee. Harry commented about his experience at First Federal:

> I was really impressed when I met Gene Rice. He told me that what was important was performance. If I performed, I would get paid for it ... 1974 has been a hard year.... I know that if the company does not hit a certain income level I will not get a bonus. It is hard to admit, but I am programming myself for no bonus. What would bother me is if we hit 75% of our corporate profit objective and we get zero reward. The company is still making millions and we should get part of the pie. If the bonus is small or nonexistent, I would wonder what all the heartache, sweat, and struggle are about. This year I think a $4,000 bonus would be fantastic, $2,500 acceptable, and anything under $2,000 very disappointing. Another important part of the bonus is that it has influenced my wife's attitude.... Branch managers tend to put in a lot of time. A $4,000 Christmas bonus can have a lot of meaning. From top management's point of view, the bonus could be a real problem because if Gene Rice pays this year, I might not be so concerned about meeting my financial objectives next year.

Another branch manager, Tom Walsh, provided more insight on the implications of Rice's decision. Tom was middle-aged, a vice president and manager of the successful Tucson branch. Tom was recruited by Rice to open up the new Tucson office. Previously, he had been employed by Prudential Insurance as a district director of mortgage loans. Tom commented about MBO:

> Before MBO, we were all striving and working hard but not in a coordinated manner; MBO has made our goals more precise. We set targets for ourselves and we direct our efforts to meet these goals. The part that I like best about MBO is that it gives me an opportunity to see my own personal contribution to the company. You know, I guess I am a company man. The company has treated me very well and I feel proud about what First Federal is trying to accomplish. When I came on board I had a major hip operation. Both Gene and George Leonard knew about the operation and that I would be laid up for a couple of months. They told me not to worry, to go up to Tucson and just talk to customers.... In regard to the bonus situation this year, I would love the extra dollars, but if it is not in the cards, I don't think I would feel sbort-changed. The company and my job reward me in many ways. We have a chance to help others, generate new ideas, and see results from our efforts.

Ray Walker managed a medium-sized branch in the southwest section of Phoenix. Walker's branch was situated at a busy intersection. Each corner of the intersection was occupied by a competing bank or savings and loan. Walker had two children and was a graduate of Arizona State University with a B.A. in business management. His present assignment was the third management position he had held since graduating from the company's management training program in 1969. Walker had a number of opinions about his work and 1974. He commented:

> I was transferred into this office and I have had to accept someone else's goals. This is a growing problem because of expansion and the promotion from within policy. I am not sure that I agree with all the targets set by my predecessor, but the point is that I still am going to be judged on those targets. Right now I am beginning to think about my targets for next year. As a branch manager I set my own goals in key areas like savings deposits, mortgage loans, consumer loans, and expenses. I submit my forecasts to the regional headquarters; sometimes we disagree and then we negotiate.
>
> This forecasting is a very complex problem. I guess the only way to do it is to thoroughly know your area. But of course no one accurately predicted what happened recently . . . This year we changed our goals in midyear. We shifted our emphasis from generating new mortgages to developing more savings deposits. In order to meet my new savings objectives, I hired six new tellers and the cost of these six tellers has placed me way above my expense budget. I know it and my boss knows it, but I do not expect to have my bonus penalized for being over budget.... The bonus plan is one of the two reasons I am here today. The other reason is the opportunity for personal growth. If there is no bonus this year there will be a tremendous morale problem among managers....
>
> At my last branch assignment in Flagstaff I received a very mediocre bonus, and boy, was I discouraged! It wasn't the dollars that were important, it was my own feeling of self-worth. The bonus tells me how much the company appreciates my work.... The severe winter storms hurt the Flagstaff tourist industry. We had over 200 inches of snow. Most businesses, instead of depositing, had to withdraw savings just to survive.... I really put out and met four out of five goals, but as I mentioned, my bonus was small. I felt that the company did not appreciate my efforts and that they were inflexible. I was eventually promoted out of the office and I often wonder in my own mind if I did a poor job there. I hope I did OK, but perhaps the company was disappointed in me.

Senior Management

George Leonard, chairman and chief executive officer, was an acknowledged industry leader and spokesman. Leonard had recently returned from Washington, where he was working with a number of congressmen on legislation that would affect the savings and loan industry. Leonard commented:

> When I joined the Association, it was an autocratic institution. All decisions were made by the managing officer. Operationally, we were just not working together and there seemed to be little commitment or cooperation. I also think we tended to be short-sighted and were making decisions that would be beneficial on a short-term basis only.
>
> I soon realized that, if we were to continue our growth and expansion, authority would have to be delegated down. With the delegation of authority and accompanying accountability, I believed that a reward system had to be set up that

would motivate young and talented managers to grow with us. While a bonus had previously been paid, I know that there was a lot of discontent because the bonus was being given arbitrarily with people at the top getting most of the dollars. One of the first things I did was to bring in some outside help, a consultant who started to make us think about our own corporate goals and industry position. These sessions led us to the conclusion that we wanted to be Number One in the savings and loan industry. To achieve this goal, we designed and implemented the MBO system and then later on tied the bonus in with achievement of MBO targets. The results have been outstanding. We have clear objectives, there is cooperation, and we have developed a group of talented and dedicated managers. This year we will not hit our target of 15% increase in profit before taxes. Our bonus is based on results, but I am concerned that we will ruin the spirit of the organization if we do not give a bonus.

Bill Blodgett was a vice president who had direct line responsibility for the 27 branch offices (**Figure B**). Blodgett felt that MBO had made significant contributions, but that he had a problem on his hands in 1974. He commented:

> In a bad economy the company may not meet its profit objectives, but I could have a number of branches that are meeting or exceeding their office objectives. How do I tell them that there is no bonus this year? How do I motivate them next year?

Another vice president, Dave Braun, was in charge of the Financial Division. Braun graduated from Arizona State University in 1937 with a B.A. in accounting, and returned to ASU in the late 1950s to earn an M.B.A. Braun commented on MBO:

> We have the problem of matching numbers with behavior. When McSweeney and Associates, our management consultants, originally sold us on the MBO approach, it was based on a rigid formula of profit attainment; 1973 was a good year with a $7,800,000 profit and we also had a good bonus. This year, the bonus situation has not been decided. We are accruing funds, but I don't know if they will be dispensed. I am not sure what my decision would be if I were Gene Rice....
>
> On one side of the argument is the position that the goals in and of themselves are important. If we don't make our targets as a company, then there just is no dollar bonus that year. Also, how can we establish believable goals if we say one thing and then do another? On the other side of the argument is the fact that everyone has made a tremendous effort this year. We have achieved some of our objectives. If we do not give a bonus, then we are not acknowledging the hard work and flexibility of our staff. We asked our managers to shift gears right in the middle of the year. They shifted from an emphasis on new mortgages to an emphasis on generating new savings accounts....
>
> We came up with a number of innovative marketing ideas, and our branch managers picked up the ball and started generating new accounts. I guess my main worry with the bonus this year is concern for motivation next year.... Would suspension of the 1974 bonus have serious negative impact on our managers?

Exhibit 1 Consolidated Five-Year Growth, First Federal Savings ($ thousands except growth statistics)

	1973	1972	1971	1970	1969
Deposits					
Passbooks	$156,270	$141,450	$106,066	$ 89,563	$ 84,153
Certificates	461,585	344,713	235,850	160,328	127,382
Total	$617,855	$486,163	$341,916	$249,891	$211,535
Loans					
First Mortgage	$622,080	$488,111	$343,734	$241,035	$196,919
Property Improvement	47,868	40,464	28,966	18,348	11,512
Mobile Home	35,977	11,218	6,527	2,312	–
Other	12,614	9,029	8,687	8,395	8,310
Total	$718,539	$548,822	$387,914	$270,090	$216,741
Growth Statistics					
Number Savings Accounts	137,703	109,415	92,867	82,610	80,019
Number First Mortgage Loans	26,072	22,540	17,998	16,099	15,409
Number Property Improvement Loans	15,872	13,471	10,674	8,149	6,225
Number Mobile Home Loans	2,046	1,128	578	177	–
Number Full Service Offices	27	22	20	19	18
Operating Results					
Total Revenue	$ 57,092	$ 41,324	$ 26,979	$ 19,648	$ 15,404
Total Expenses	46,414	32,810	22,493	17,548	13,885
Income Before Income Taxes & Extraordinary Items	10,678	8,514	4,486	2,100	1,519
Income Taxes	2,850	2,100	835	370	245
Income Before Extraordinary Items	7,828	6,414	3,651	1,730	1,274
Extraordinary Items	–	–	668	–	–
Net Income	$ 7,828	$ 6,414	$ 4,319	$ 1,730	$ 1,274

Source: Company annual report

Exhibit 2 Consolidated Statement of Income, First Federal Savings and Wholly Owned Subsidiaries

For the six months ended June 30	1974	1973
Revenues		
Interest on loans	$29,291,641	$21,225,843
Loan fees and service charges	4,462,150	3,171,001
Investment income	2,260,391	1,290,610
Real estate operations, net	624,362	368,920
Other	799,976	818,433
	37,438,520	26,874,807
Expenses		
Interest on savings deposits	21,435,918	14,673,396
General and administrative expenses	8,007,838	5,083,259
Provision for loan losses	74,863	0
Other interest expense	3,480,144	1,326,407
	32,998,763	21,083,062
Income before income taxes	4,439,757	5,791,745
Provision for income taxes	1,240,344	1,542,180
Net Income	$ 3,199,413	$ 4,249,565

Exhibit 3

Carrot & Stick

More Concerns Tie Bonuses to Meeting Goals for Workers

Programs Spur Employes To Do More, Firms Say: But Some Problems Seen

A Link to the Crime Rate

By ROGER RICKLEFS
Staff Reporter of THE WALL STREET JOURNAL

Fourteen years ago, when Gene E. Rice was a branch manager of First Federal Savings & Loan Association of Phoenix, he received an annual bonus of exactly $880, and he didn't like it. "All the branch managers and all the vice presidents got the same thing. I thought I was working harder than the rest and I thought I should be paid more. So it was a negative incentive," he says.

Now Mr. Rice is president of the bank, and he has a bonus plan that he likes a lot better. Today payouts range up to 40% of salary and down to nothing. The amount depends on the individual's performance against pre-established goals, ranging from the number of new savings accounts to the number of speeches delivered to real-estate groups.

The new bonus plan, which grew out of the "management-by-objectives" program the bank started in 1968, has "definitely encouraged people to work harder and has also helped us attract good people," Mr. Rice says.

Like First Federal, hundreds of companies have adopted management-by-objectives or similar plans in recent years, but they operated independently of bonus programs. The more jaded executives have often figured that they were just another management fad. But now companies are giving these programs the bite that counts: They're tying the plans to the size of paychecks.

"A Growing Practice"

"Five years ago, setting the bonus on the basis of management by objectives was a rarity, but today it is a growing practice," says George A. Goddu, a principal and compensation specialist at Peat, Marwick, Mitchell & Co., the large accounting firm. Recently, International Business Machines Corp., Bendix Corp., CNA Financial Corp., PepsiCo Inc., and numerous others have all moved in one way or another to relate their bonuses more directly to the recipient's actual performance.

One result is that in companies where almost everybody with comparable rank could count on getting similar bonuses, executives now find their peers getting bonuses much smaller—or much bigger—than their own. Some of them are shocked by the discovery, especially when the difference may amount to thousands of dollars.

At First Texas Financial Corp., a Dallas savings-bank holding company, bonuses used to range up to 10% of salary. Starting last year, they ranged from zero to 30% of pay. Until last year, nobody at Norton Co., the large Worcester, Mass., abrasives maker, received any bonus. But in a new plan for 130 executives, some got a 30% bonus last year, and seven hapless managers again received nothing, the company says.

Bonuses of 100% of Salary

One Midwestern conglomerate started a new plan last year with specific performance goals and potential bonuses ranging up to 100% of salary. This replaced a program that left awards completely to management's discretion and paid 10% to 18% of salary, says Frederick A. Teague, vice president and compensation specialist at Booz, Allen & Hamilton Inc., management consultants.

Sometimes the new programs generate enormous sums for executives who rate highly. In a new performance-oriented plan at IBM, Frank T. Cary, chairman, earned a bonus of $246,000 last year, well over his salary of $200,000.

But sometimes, too, subordinates get awards while their bosses get nothing. At CNA Financial, the big insurance, finance and real-estate concern, where corporate earnings declined last year, the top officers didn't receive any bonuses. At subsidiaries, however, bonuses ranged up to $25,000, Frank Metzger, senior vice president, says.

Practically all of the new plans operate by setting fixed goals in advance, usually starting with profits. At First Texas Financial, for instance, the new bonus plan has a profit goal "that has to be met or nothing else happens," John L. Ingle, president, says. But in addition, the Dallas bank-holding company sets profit goals for individual

Exhibit 3 (continued)

units, then looks at other factors such as penetration of market in a given field, reduction of operating expenses and improvement of facilities.

What's a "Good Job"?

Of the nation's largest 100 companies, probably 30 to 40 now set bonuses by some sort of pre-agreed formula for what constitutes "a good job" and vary the awards from one profit center to another, says Graef S. Crystal, vice president of Towers, Perrin, Forster & Crosby Inc., compensation consultants. This figure compares with only five to 10 companies five years ago, he says. In addition, some companies, including PepsiCo, say they are constantly striving to make the goals more specific and detailed.

Companies find that the bonus plans can encourage the pursuit of all kinds of goals, not just increased profit. A plan started last year at Bendix includes routine financial goals but also adds objectives in "management development," minority and female employment and safety and health, says Kenneth L. Otto, vice president for personnel and organization development. Thus, a Bendix executive's bonus now depends in part on how well he conducts college recruiting, provides able executives to other units of the corporation, works with high schools to attract minority employees and meets goals for upward mobility of women and blacks, the official says.

J.C. Penney Co., which has paid cash bonuses based on annual results for many years, started a program in 1971 that awards bonuses in Penney stock based on results over a three-year period. "We wanted to get people interested in longer-range development," Ronald A. Johnson, compensation manager, says.

Outside of business, the incentive-bonus principle is being applied to crime fighting. The Orange, Calif., police department last year started a program that boosts police pay if crime declines in four categories considered responsive to improved police prevention work: burglary, robbery, rape and auto theft. So far this year, crime in these categories has declined 17% from a year ago, and the police have received one raise of 2%, Police Chief Merrill Duncan says. As a check against fiddling with statistics, outsiders audit the program by monitoring reports of police calls he adds.

Many companies say they are pleased with the performance-bonus approach. "You see results right away," says Samuel N. Hibbard, Norton Co.'s director of compensation and financial benefits. "An incentive plan focuses effort on what management wants effort to go into."

Knowing What Is Expected

By the same token, the new programs also help executives know exactly what management expects and why they are getting the money. Bendix Corp.'s Mr. Otto, who has pushed performance bonuses, says: "When I came here two years ago, I asked people, 'Do you know how you earned your bonus last year?' Most people didn't really know, and that is what got me on this kick."

In addition, companies say the specific goals and criteria of the new incentive programs force executives to reward the high performers and to squeeze the inept. "Our bonuses previously tended to be more or less the same for everybody," says Roland Beers, PepsiCo's personnel vice president. "Executives are reluctant to differentiate."

Mr. Crystal of Towers Perrin says that "if there isn't some sort of formula, everybody tends to get the same thing because you can't blame the disparity of awards on an inanimate object. If you have an infinite amount of discretion, you don't use any." The consequent similarity of bonuses grates on the strong performers who feel they aren't being recognized, executives say.

Problems With the Plans

But performance-bonus plans take time to set up and can create problems of their own. "Nobody has ever designed a plan like this that worked right the first time," says Mr. Ingle of First Texas Financial. "Some of the goals we set had to be shifted around during the year due to things happening over which we had no control," he adds.

Mr. Crystal of Towers Perrin adds: "A lot of companies try basing the awards on meeting budgets. This gives the division manager a motive to set the budgeted profit too low. In some companies, people are always pleading to readjust the formula. It can get to be sort of like the chairman of the board holding night court."

Mr. Crystal says that one New York conglomerate that used to pay executives fairly similar bonuses switched in 1970 to bonuses based on divisional performance, but it went back to the old system last year. "The problem was that half the division heads got nothing, the others got up to $50,000 a year and the chairman wasn't sure that the right people were getting the $50,000. One big problem was a division president who got a huge award. But he had done well mostly because a key competitor was on strike for six months," Mr. Crystal says.

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