

SNF Report No. 16/09

Performance measurement and incentives

A study on performance management in a changing environment

by

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SNF Project No. 7980
Beyond Budgeting – Research Program

The project is financed by StatoilHydro ASA

INSTITUTE FOR RESEARCH IN ECONOMICS AND BUSINESS
ADMINISTRATION
BERGEN, AUGUST 2009

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ISBN 978-82-491-0661-5 Printed version
ISBN 978-82-491-0662-2 Online version
ISSN 0803-4036

Preface

This thesis is written as a part of the Master of Science in Economics and Business Administration program at the Norwegian School of Economics and Business Administration (NHH), with a major in Business Analysis and Performance Management (BUS). The thesis is written on commission from the Institute of Research in Economics and Business Administration (SNF) and is financed by StatoilHydro.

Studying the field of Beyond Budgeting and the developments of performance management systems require extensive information. Writing a thesis based on comprehensive theoretical as well as empirical research has been an inspiring and educational experience. Without assistance from StatoilHydro, this would not have been possible. My sincere thanks go to the managers who volunteered for the research project and to the project manager at StatoilHydro, Bjarte Bogsnes, for facilitating the process.

I sincerely express my gratitude to my supervisor, Katarina Østergren, for remarkable assistance and constructive suggestions throughout the process. Furthermore, I am grateful for comments and inspiration from the research team, consisting of both master students at NHH and their supervisors; Trond Bjørnenak, Daniel Johanson and Inger Stensaker. The team collaboration has been of great help in structuring the work and keeping the enthusiasm and creativity high at all times.

Bergen, June 18th 2009.

Nina Birgithe Haraldsen

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Chapter 1: Introduction

The aim of this chapter is to introduce the problem statement and its theoretical background. Furthermore, this chapter will introduce the relevance, empirics, scope and structure of the research and the thesis.

1.1 Report background

As recognized by numerous companies and researchers during recent years, the business environment is becoming even more demanding and unpredictable. High paced economical and technological development, in addition to a more volatile and unpredictable marketplace, imply a higher focus on how to manage and lead the businesses. Focus should move from detailed traditional accounting systems, to more flexible and strategically focused management control systems (Wallander, 1999; Bjørnenak, 2003).

During the “Relevance Lost” debate in the late 1980’s, Johnson and Kaplan (1987) initiated their theories of “A Performance Measurement System for the Future”. They stressed the importance of assuring congruence between long term strategic objectives of the company, and short term goals for control and performance management. They also highlighted the possibility of using non-financial measures, as short term financial measures often are invalid indicators of the actual recent overall performance of the enterprise (ibid).

Among others, Merchant and Van der Stede (2003) published their theories and findings on management control systems and the issues of performance measurement in the 1990’s. In order to achieve success, the performance management system must ensure that every individual employee acts in the desired way – contributes to increase firm value (ibid). The design of this control system and the measurement of each employee’s contribution to shareholder value, are difficult, but not impossible. Merchant and Van der Stede (ibid) discussed how to use both accounting performance measures and non-financial measures in the performance measurement system. They also examined the use of financial result control in the presence of uncontrollable factors.

A strategic management control model connecting long term strategic goals with short term actions is the Balanced Scorecard, introduced by Kaplan and Norton in 1992. It links

performance measures from all organizational levels with the overall company strategy, using four perspectives; financial, customer, internal processes, and innovation and learning. Today we observe many versions of the Balanced Scorecard in both multinational organizations and smaller companies. One of the challenges for achieving company success is combining the strategic management system with the performance measurement system, consisting of goals, measures, evaluation and incentives.

In order to meet today's business challenges and stay competitive, many companies renew and innovate their performance management systems. They witness the challenges and are willing to go in new directions to reach strong sustainable results. The Beyond Budgeting initiative recognizes the weaknesses of traditional control systems of budgeting and accounting measures of performance. Some perceive traditional budgeting as insufficient in today's highly uncertain and competitive market. The future is unknown and a budget is no more than a best guess about the future (Wallander, 1999). When the budget acts as a resource allocation system, a performance measurement system and planning tool, the performance will never be outstanding (Bogsnes, 2006).

In 2009 Bogsnes published the problems with traditional management control systems, and suggested new methods in the new business environment. StatoilHydro is a Norwegian multinational oil and gas company that has implemented the Beyond Budgeting mindset throughout the entire organization. Traditional budgeting processes have been abandoned and forecasts, resource allocation and performance management systems are now defined as separate processes. However, in order to achieve organizational excellence these processes must act together in a dynamic management control system. The strategic management approach named "Ambition to action" combines strategic objectives, key performance indicators and actions. These are directly linked to the performance measurement system, with individual goals and evaluation. Furthermore, individual performance is rewarded based on delivery and behaviour; a holistic assessment (StatoilHydro Annual and Sustainability Report, 2008).

Nonetheless, performance management is always a challenge. The purpose is to ensure that every unit of the organization strives towards the same goal. This should be guaranteed by a sophisticated strategic management system defining the value drivers and strategic objectives. Additionally, the right key performance indicators with goals, actions and incentives should

be assigned the different units of the organization, both divisions and individuals. If designed and implemented successfully, the performance management system will secure high productivity and motivation at the workplace, and act as an important element in achieving business excellence and sustainable results (Merchant and Van der Stede, 2003).

Furthermore, one must recognize the performance management challenge of combining the performance measurement systems with human resource management systems such as pay and compensation, performance dependent rewards and punishments, promotions and career plans. Gooderham and Nordhaug (2003) have conducted several research projects in the field of human resource management and especially international human resource management and related issues. They emphasize the importance of human resource management systems for performance, results and motivation at the work place. A key issue is how to understand the relationship between performance measurement and incentives, and how this has implications for management control practices. The French researcher Bourguignon (2004) has published several papers on the relationship between the two systems, and addresses the need for more research in this less studied field.

1.2 Problem statement

The problem statement of this study is as follows:

What is the relationship between performance measurement and incentives?

Addressing this problem statement will involve a three-step process. Firstly, the developments of management control systems, performance measurement and incentives will be studied both theoretically and practically. Secondly, the present performance measurement and incentive systems in a larger international company will be examined. Third, main research findings with implications for management control practices will be identified and discussed.

1.3 Relevance

The relevance of this study is the research on the combination of performance management and a new management control system; the Beyond Budgeting ideology. Research and literature highlight the new ideas on how to manage and lead businesses in today's unpredictable environment. There are numerous studies on alternative management control

methodologies, like the Balanced Scorecard and Beyond Budgeting. However, a challenge is to connect these with performance measurement and incentives, in order to accomplish system congruence and sustainable returns.

The aim of the thesis is to give a better understanding of the implementations of performance measurement and incentive systems with a linkage to Beyond Budgeting. This is a field less explored by research and literature. Furthermore, this study is relevant for companies implementing a mixture of financial and non-financial performance measures and connecting these with incentives, both in a budgeting and a non-budgeting environment.

1.4 Empirics

The methodology used in this thesis is in depth interviews with managers at StatoilHydro, in addition to available reports, plans, procedures and models describing the theoretical performance management system. The “Ambition to action” plan contains models and processes on strategy, key performance indicators, and performance measurement and incentives. Qualitative interviews will be the background for analysing the design, implementation and use of the performance management model at StatoilHydro.

The report looks at the development of performance measurement and incentives over time. In depth interviews are important for understanding both the development and the present systems, and their impact and significance. Relevant theories and literature are used as a theoretical perspective for information gathering. Interviews with human resource managers are conducted with a focus on system development, design and implementation. These interviews are important in order to understand system design, reason, and implementation. In addition, interviews with other managers are necessary in order to understand system impact, significance and use.

1.5 Scope and structure

The thesis will focus on the performance measurement and incentives systems, and their development during recent years. In order to analyse this, one must describe the entire management control system, which includes strategic objectives, key performance indicators and actions. In addition, one must describe and thoroughly analyse of the performance

measurement methods and the incentive systems. Conclusively, the developments, the challenges with the different systems and the implications for management control practices are examined.

In order to answer the problem statement within the scope of this report, both the theoretical and practical view must be examined. The first chapter of the report is the introduction. The second chapter contains a theoretical background on the field of management control systems, performance management and the developments. Chapter three describes research design and methodology. Chapter four includes the empirical data; the fundamental empirical information necessary for the analysis. Chapter five is the actual analyses, including analyses of performance measurement and incentives, and a discussion of the research findings and their implications. The theoretical framework from chapter two will be used for this analysis. Chapter six is the conclusion of the report, with a summary of the main findings and some suggestions and proposals for further research.

Chapter 2: Theoretical perspective

What tools and managerial approaches that are needed to create a high performance workplace and a sustainable competitive and profitable business have been heavily debated in recent year's management accounting literature and research. The theoretical proposals are many and diverse, and they offer different suggestions to both performance measurement and incentives. This chapter will give a theoretically structured model for studying performance measurement and incentives, and thereby explains the theoretical perspective needed for addressing the problem statement:

What is the relationship between performance measurement and incentives?

This chapter will firstly describe the historical *developments of management control systems* and practices, with an explanation of the recent developments. Secondly, in order to address the relationship between performance measurement and incentives, this chapter will examine both *performance measurement* and the connection to the *incentive system*.

Furthermore, the theoretical perspective will conclude in a clear model to act as the foundation for research design and method, and the analytical discussion including the final research conclusions.

2.1 Developments of management control systems

The traditional definitions and meanings of the term management control were given by Anthony (Nyland and Østergren, 2008). He distinguished management control from strategic planning and operational control and defined it as *is the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's objectives* (Otley, 1987).

This theoretical perspective divides management control into four control processes; strategic planning, budgets and plans, performance and measurement and results and evaluation. This management control or budgetary system has traditionally been an annual process, given by Anthony and Young (Nyland and Østergren, 2008), as illustrated in figure 2.1.

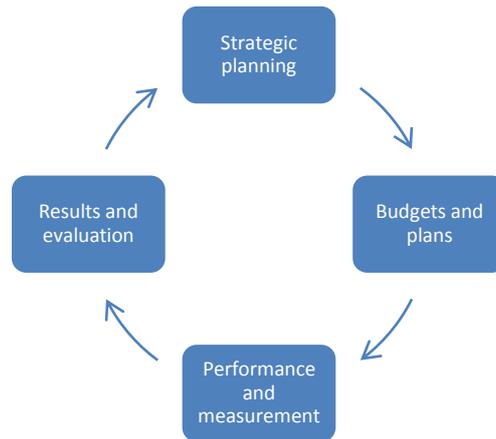


Figure 2.1: Traditional management control process

Merchant and Van der Stede (2003) introduced a broader definition, and described management controls as processes to ensure that the employees do what is best for the organization. More precisely Simons (1995, 2000) defined management control systems as *the formal, information-based routines and procedures managers use to maintain or alter patterns in organizational activities*.

Furthermore, Simons (1995) introduced a theory for describing the management control system, a framework based on four levers of control; belief controls, boundary controls, diagnostic controls and interactive control systems. Diagnostic control systems are used by managers to monitor results, profitability and progress, and to ensure that important objectives are achieved effectively. These are only lag indicators of business performance, and therefore not sufficient as a complete management control system. Boundary systems identify the rules, regulations and desired actions. By stating what behaviours and actions are not acceptable, management allows for innovation within certain clear boundaries. Together with diagnostic control, boundary control systems ensure control with relation to plans and strategy. Belief systems are formal value and mission statements to inspire and promote commitment to the company's core values and beliefs. Interactive control systems are the formal information systems managers use for regular and personal involvement in the decisions of subordinates, and are used to strategically monitor and learn from the changing environment. Belief systems and interactive control systems are based on culture and values, and are used to support innovation, creativity and double-loop learning (Simons, 1995; Tuomela 2005). The aim of the control system is to make these levers of control act together in a balance, in order to

account for strategy, management control and performance management; a full-scale control system ranging from organizational strategy to individual performance.

However, problems arise because of weaknesses in the management control system, and hinder the employees from acting in the organizations best interests. Merchant and Van der Stede (2003) defines three main categories of causes of management control problems. First of all, some employees perform poorly because they are not certain about what the organization wants from them; they experience a lack of direction. Secondly, many employees experience lack of motivation, often because the sacrifice of doing what is expected exceeds the rewards given. Another reason may be that organizational goals and personal goals are not aligned, resulting in employees acting in their own personal interest. The final reason for management control problems are personal limitations. The employee knows what is expected and is highly motivated but lack the training, experience or knowledge needed to perform.

There are several ways of addressing the control problems mentioned (ibid). One way is direct control of the employees, with legal or structural limitations and clear boundaries. Another possibility is centralization of decision-making, and this is frequent in many smaller businesses with strong management. Annual budgeting processes have been a traditional way of controlling decentralized divisions and projects, and still maintain an authoritarian line of command and control and centralized decision making. Another common and more recent way to solve the management control problems are through design of a complete management control model; a collection of control mechanisms (Simons, 1995; Merchant and Van der Stede, 2003). Such a system may include results controls, action controls, personnel controls and cultural controls (ibid).

Another common way of management control focusing on value creation is decentralization, which has proven successful in many organizations such as the Swedish bank Handelsbanken (Wallander, 1999; Hope and Fraser, 2003). With drastically decentralized operations they emphasize the importance of an external focus on customer needs and preferences, as well as their competitors. Giving the decentralized divisions accountability and responsibility is a way to understand the customers and their needs. However, these divisions need a solid management control system. One solution is a management by objectives system defined as *a process whereby the superior and subordinate managers of an organization jointly identify its*

common goals, define each individual's major areas of responsibility in terms of the results expected of him, and use these measures as guides for operating the unit and assessing the contribution of each of its members (Odiorne, 1965).

One such management by objectives system should include a set of value drivers. These are leading indicators of value creation in the organization; the critical success factors of what to concentrate on today in order to create value tomorrow (Merchant and Van der Stede, 2003). Kaplan and Norton (1992) suggest the Balanced Scorecard, where business strategy is broken down into key performance indicators of financial, customer, internal processes, and learning and growth perspectives. This set of performance measures will have many advantages. They link individual goals with overall organizational objectives and business strategy, thereby balancing short term and long term objectives. Also, the measures provide a timely performance evaluation, on both lead and lag, financial and non-financial measures (ibid). Kaplan and Norton (1996) advise that a scorecard should contain both outcome measures and the performance drivers of those outcomes, linked together in a clear cause and effect relationship.

Nevertheless, many researchers have studied Balanced Scorecard approaches in practice. Malina and Selto (2001) conclude that the Balanced Scorecard is an effective tool to align business strategy and performance management and to focus on improvements. However, they find that inaccurate and subjective measures destroy some of the value. One of their suggestions is to keep the measurement system both cognitively and administratively simple, with a limited number of performance measures. Nørreklit (1999) finds that the underlying assumptions of cause-and-effect relationships in the Balanced Scorecard is not always obvious, for instance that superior customer satisfaction is not perfectly correlated with high financial results. She concludes that Kaplan and Norton's control model is a too hierarchical top-down model, not always sufficient in today's dynamic environment. She suggests that the control process should be more interactive during strategy formulation and implementation.

The issues of uncertainty are becoming more and more relevant, and rolling forecasts is one suggestion to cope with the changing environment. Rolling forecasts or rolling budgets have the same length, normally a year, but is regularly updated with the previous as a starting point. This means that a full year planned budget is always available, but will be adjusted for changes as a routine, in order to get a better understanding of the market and business

conditions (Hansen et al., 2003). Another commonly used tool is benchmarking, where the organization regularly compares its results and market share with that of similar competitors (ibid). This method will focus on actual value creation and addresses some of the problems of external uncertainty in the marketplace.

Furthermore, the management control system should separate the planning and forecasting process, the resource allocation process and the performance management process (Bogsnes, 2009) to ensure high quality of all three processes and no conflicting interests. Many researchers have recently addressed the shortcomings of traditional budgeting practices (Hansen et al., 2003; Hope and Fraser, 2003). The Beyond Budgeting philosophy is a new way of addressing management control challenges, replacing budgets and making organizations more adaptive to change (The Beyond Budgeting Roundtable, 2009). The new ideas combine tools and processes of management control, like benchmarking, rolling forecasts, relative performance goals and dynamic resource allocation, in addition to a set of leadership principles (Bogsnes, 2009). The international network Beyond Budgeting Roundtable identifies 12 principles as suggestions on how to implement a Beyond Budgeting methodology:

Leadership actions:

1. Customers: Focus everyone on their customers, not on hierarchical relationships.
2. Processes: Organize as a lean network of accountable teams, not as centralized functions.
3. Autonomy: Give teams the freedom and capability to act, don't micro-manage them.
4. Responsibility: Create a high responsibility culture at every level, not just at the centre.
5. Transparency: Promote open information for self-management, don't restrict it hierarchically.
6. Governance: Adopt a few clear values, goals and boundaries, not fixed targets.

Aligning management processes with leadership actions:

1. Goals: Set relative goals for continuous improvement, don't negotiate fixed contracts.
2. Rewards: Reward shared success based on relative performance, not fixed targets.
3. Planning: Make planning a continuous and inclusive process: not a top-down annual event.
4. Controls: Base controls on relative indicators and trends, not variances against a plan.
5. Resources: Make resources available as needed, not through annual budget allocations.
6. Coordination: Coordinate interactions dynamically, not through annual planning cycles.

2.2 Performance measurement

When it comes to performance management, there are diverse and complex challenges. From an objective point of view, the primary goal of any for-profit organization is to maximize shareholder value. Consequently, the performance management system should reward every employee for maximizing the firm value. In order to ensure value creation and high performance, the management control system must include a performance measurement system. Secondly, the performance measurement system must be connected to an incentive system. This chapter will examine the issues of performance measurement and the next chapter will discuss incentive systems.

In order to strive for excellence and sustainable results, every employee should work towards the same goals, and the right goals. When addressing performance measurement two issues are central. Firstly, the organization must strive to set the right key performance indicators and measures. This means formulating them correctly, making sure that overall business strategy and value creation are reflected, and account for the uncertain and changing business environment. Secondly, the organization must bear in mind the behaviour problems possibly caused by the performance measures. The following theoretical assessment will first discuss *goal setting*, then the possibility of *behavioural displacement problems*.

2.2.1 Goal setting

From traditional management by objectives (Odiorne, 1965) and project management emerged the theory of critical success factors (Daniel, 1961). These are the parameters required in order to reach success, or in project management; the deliverables that must be achieved in order for the project to succeed (Gardiner, 2005). In management accounting critical success factors are often described as long term strategic objectives. Once these are determined, one must identify what needs to be done to get there, also called key performance indicators or action objectives. These performance measures are essential in assuring that everyone pulls in the same direction and focuses their attention on the right activities (Locke and Latham, 2002).

When using a management by objectives approach, for instance the Balanced Scorecard, the objectives and actions can be numerous. However, a traditional suggestion is to make them SMART (Gardiner, 2005; Shields, 2007). The performance measures should be *specific*, so

that everyone knows what is involved, *measurable*, so everyone knows what success is, *ambitious* but *achievable*, to keep enthusiasm high, *relevant*, to reflect overall business strategy, and *timely*, for effective time management (ibid). The following discussion of performance measures is structured after this traditional way of looking at goal setting.

Goals should be specific and measurable

Locke and Latham (1990, 2002) found that goal specificity is one of the most important criteria in goal setting. Unclear goals like “do your best” will not result in high performance, the goals need to be specified (ibid). Goal specificity reduces the variances in performance due to a common comprehension of what is to be attained (ibid). They also found that specific but difficult goals led to higher performance than vague statements like “do your best”; this is because these types of goals do not have any external references. According to Merchant and Van Der Stede (2003) one of the most common management control problems is that employees do not know what is expected from them, one reason can be that they do not understand their measures or how to perform. Furthermore, performance goals should be measurable (Shields, 2007). In order to allow for progress and follow ups, performance measures must be valid and quantifiable (ibid). If success on the parameter is difficult to measure, the management control problems are a fact. The employee needs to know what is expected and how to measure success. Conclusively, performance measures should be specific and measurable.

Goals should be ambitious but achievable

In order to strive for superior results, performance measures need to be ambitious. In their meta-analysis Locke and Latham (1990, 2002) found that the highest or most ambitious goals produced the highest level of effort and performance. However, the performance decreased when the limits of abilities were reached or when commitment to the goals faded (ibid). Furthermore, they say that commitment and performance may be higher if people participate in their own goal setting process. They argue that people with high self-efficiency will set higher goals, be more committed and perform better if participating in their own goal setting process. On the other hand, people with low self-efficiency will set less ambitious goals and perform more poorly if they are participating in the goal setting process; compared to goals set without their participation (ibid). Conclusively, goals should be ambitious to a given point; where commitment or abilities are reached.

Nonetheless, the goals should be achievable. In relation to goals achievability, Merchant et al. (1987) describe the controllability principle, which says that people should only be held accountable for what they can control. Furthermore, Gabrielsen et al. (2007) explain several serious static incentive problems. If results on the measures have unclear correlations with the actions, the employee is forced to bear unnecessary business risk. Employees are in general risk averse, and making them accountable for measures they cannot sufficiently control consequently creates large risk premiums. This is directly related to the controllability principle.

A common challenge is performance measurement in the presence of high uncertainty, as often witnessed in today's business environment. Merchant and Van der Stede (2003) identify three types of uncontrollable factors; economic and competitive factors, acts of nature and interdependence, the last one meaning measures that are affected by more than one person in the organization. They suggest adjusting the performance results for uncontrollable factors after the measurement period. This might be a solution to manage the controllability principle. However, one of the main motives of the performance measurement system itself may be neglected; giving employees exact and measurable goals to work towards. Many studies have been conducted in this field. Giraud et al. (2007) find that managers to some degree do accept uncontrollability; they are more concerned about what they can influence rather than what they can control. Nevertheless, they find that managers want the controllability principle to be applied due to reasons of fairness, especially in relation to internal uncontrollable factors. Conclusively, the organization must account for the controllability principle in goal setting, and secure achievable goals.

Goals should be relevant

Merchant and Van der Stede (2003) emphasize that the performance measures should be congruent with overall organizational goals and business strategy, in order to motivate the right actions. However, they state that most firms base their performance measures on accounting profits and their components, such as revenue, costs, assets and returns. Comparing budgets and results, using so called accounting or financial measures, has traditionally been a relatively easy, standardized and objective method for upper-level management to evaluate and control performance in the organization. However, accounting measures are not a perfect measurement of performance; they are only substitute indicators of changes in firm value and can create significant control problems (ibid). Accounting systems

are transaction oriented, not value creation oriented. Huge value can be created through intangible assets, human capital and research and development, without any positive changes in the accounting measures. Additionally, accounting measures focus on the past, not the future; they are lag indicators of performance (ibid). Conclusively, the set of performance measures need to reflect overall business strategy and actual value creation; they need to be relevant.

Goals should be timely

Lastly, goals should be achievable within a predefined timeframe (Shields, 2007). Efficient time scheduling is necessary for goal accomplishment, in addition to continuous feedback (ibid). However, one challenging issue in order to be dynamic is what measurement period to assign the different measures. Some business fields are subject to fast paced changes, and short term measures, such as weeks or months, would be appropriate. On the other hand, for longer term strategic measures several years might be a sufficient timeframe. However, the importance of timely goals is the agreed clear timeframe. Thus, goals should be timely.

2.2.2 Behavioural displacement problems

From a management control point of view, accounting measures of performance can create a number of behavioural displacement problems (Merchant and Van der Stede, 2003). Behavioural displacement occurs where the control system encourages behaviours that are not consistent with what the organization wants (Merchant, 1985). Choosing the wrong performance indicators, assigning them to the wrong units or not weighting them properly, might result in dysfunctional behaviours. This chapter will discuss the challenges caused by *myopia problems*, or short-sightedness, challenges with *too few or too many* performance measures and *other behavioural displacement problems*.

Myopia problems

One serious problem with performance measurement is myopia, or short-sightedness, where managers are more concerned with short-term profits than long term value creation (ibid). Investment myopia is a problem due to the fact that accounting systems only recognize profits when revenues are realized. So investment opportunities will give short term loss, and managers are stimulated to minimize costs in the short term, thereby neglecting some investment opportunities. Thus, they might sacrifice long term strategic objectives for short

term accounting profits. Operating myopia is a displacement problem where managers increase short-term operating profits, while potentially destroying future profits. Examples are boosting of sales in one period, while possibly destroying goodwill and future earnings.

Too few or too many

Using too few performance measures may result in narrow-minded employees, and using too many may overwhelm and diffuse the employees. On one side, Kaplan and Norton (1992, 1996) suggest the Balanced Scorecard as a strategic management and performance measurement tool, with a great number of key performance indicators and measures. On the other side, to address every important aspect a Balanced Scorecard will have more than 20 different measures. This means that no measure will have more than some percentage effect on the overall evaluation and no single measure will have a greater impact (Merchant and Van der Stede, 2003).

Another issue is the challenge of multi-tasking (Gabrielsen et al., 2007). If the job description is diverse and contains multi-tasking, making the employee accountable for only some of the tasks will result in a mistaken focus of attention. The employee will be narrow-minded and neglect important issues in the work assignment.

The French researcher Bourguignon studies the relationship between management control systems and human resource management systems (Bourguignon, 2004). She finds that when people are confronted with too many performance evaluation criteria, they tend to focus on the ones they perceive as most important. This will result in dysfunctional behaviour, with managers interpreting the set of performance goals differently throughout the organization. Furthermore, she finds this phenomenon to be most challenging when the evaluation criteria are sourced both in the management control system and in the human resource management system. Malina and Selto (2001) suggest keeping the measurement system cognitive and administratively simple, with a limited number of performance measures.

Other behavioural displacement problems

There are also challenges concerning how to set the individual goals. If the performance of one period is subject to goal formulations in the next period, the employee is given incentives to minimize effort in the first period. This is called the ratchet effect (Laezar and Gibbs, 2008). Gabrielsen et al. (2007) separate static from dynamic incentive problems. Dynamic incentive

problems arise when the manager decides to change the incentive systems when new information is available. This is one way to cope with uncertainty; even so the system will only work properly if it is stable and predictable. For instance, if the performance of one period has consequences for changes in the system, the results might be unfair, biased or result in a ratchet effect.

Another serious issue concerning performance measures is manipulation, where managers manipulate their results in order to obtain a high score on the performance measures. Merchant (1985) uses the term gamesmanship to refer to actions managers take that might improve their measures without yielding any positive economic outcome. Furthermore, he claims that these problems are connected to financial accounting measures only. Nørreklit (1999) emphasizes the importance of the employee's internal commitment to the business strategy and the performance measures, in order for the performance management system to have a greater impact in the organization. The internal commitment is internal motivation and dedication for work assignments and measures. On the other side, external commitment includes variables outside oneself, like managers' orders and organizational incentives. If the external commitment is too high, it may motivate employees to focus all their attention on the measures. This is especially problematic if the organization uses only financial measures, and the risk of manipulation is present. Nørreklit (*ibid*) suggests a set of performance measures, both financial and non-financial, that are rooted in the employees' internal commitment.

2.2.3 Conclusions of performance measurement issues

As argued, the challenges of performance measurement and incentive systems are many and diverse. In her dissertation, Friestad (2008) identifies four requirements for performance measures useful for a final evaluation of the performance measurement system. Number one, she suggests that the set of performance measures used should be relevant. This means that measures are aligned with overall goals and business strategy, and are clearly related to value creation and the organizational value drivers. To be relevant, an obvious cause-and-effect relationship must be present (Tuomela, 2005). Number two, performance measures are precise if they measure what they are supposed to measure. The implications are that it should not be possible to manipulate the results. It can be complicated to make measures precise if the measurement is subjective; therefore objective measures are more accurate. Number three, the set of performance measures is complete with an ideal number of measures, not too few

and not too many. It is important to suppress dysfunctional behaviour, as can be the case if the measures are narrow and too focused. Kaplan and Norton (1996) suggest the Balanced Scorecard as a strategic management and performance measurement tool, with a great number of key performance indicators and measures. Number four, Friestad (2008) suggests that the performance measures should be responsive. Consequently, it must be possible for the measures to be highly influenced and controlled by the individual or department accountable. This is related to the controllability principle (Merchant et al., 1987), saying that the measures should be highly sensitive to and correlated with the actions taken by the employee. This also relates to the level of answerability and control within the specific position; the employee must be able to make the decisions and necessary actions to perform.

2.3 Incentive system

The final element of the management control system and the performance management system is the incentives connected to performance measurement. Incentives are important because they inform and remind employees what results are desired, and motivate them to achieve and exceed the performance measures (Merchant and Van der Stede, 2003). This chapter will firstly explain some theoretical assumptions for *incentives*. Secondly, the importance of *fairness* will be discussed. Lastly, some *evaluation criteria* will be suggested.

2.3.1 Incentives

Human resource departments have traditionally administrated the personnel functions of the organization, in respect to selection, training, promotions, employee relations, personnel data, pensions, pay and compensations. Human resource management is a more modern used term, addressing the traditional functions of human resources in addition to serving the functions of performance evaluation and management and individual career developments. In connection to performance management, human resource functions can be seen as “consequences” of the performance measurement system, such as performance based pay, promotions, job security or punishments like reassignment. These consequences are defined as incentives.

The most common theory used for incentive systems is the principal-agent theory (Rees, 1985). When a principal hires an agent to act on his behalf, problems of asymmetric information and moral hazard arise. Asymmetric information is a situation where the agent,

here the manager or employee, has more information about the situation, the business and management than the principal, here the shareholders. Moral hazard is the situation where the principal and the agent have conflicting interests. In these circumstances the agent will act to optimize his personal interests, not the interests of the principal. In order to solve some of these issues, the principal will attempt to align the objectives of the agent with his own objectives. These attempts are often in the form of sophisticated job descriptions and performance measures strongly tied to the incentive system. In theory, if there are no risks for the owner, incentives would not be necessary. This might only happen if the goals of the agent are exactly the same as those of the principal, and the agent is highly motivated and capable of performing.

One solution to the principal agent problems is significant use of incentives programs, in order to align the goals of the principal with the goals of the agent. Traditionally punishments have been used as intensive incentives. Today's incentives are more positively charged, such as recognition, pay and compensation. However, absence of positive incentives can sometimes be regarded as a punishment (Merchant and Van der Stede, 2003). Laezar and Gibbs (2009) argue that employees tend to respond strongly to incentives, and thereby make incentive systems an important source of value creation if designed correctly. Nevertheless, if designed poorly, they argue that the incentive system can result in value destruction (ibid).

As discussed by Bragelien (2003), individual performance based rewards are becoming more and more common in today's businesses. He explains that one reason for this can be the changes in work assignments. Some years ago a majority of the work assignments could easily be described and directly controlled. However, today many assignments and positions require flexibility and a high degree of independent decision making, especially in knowledge intensive organizations. This makes control more difficult and powerful incentives an alternative control mechanism (ibid). In this manner, strong incentives are used as a mean of addressing the principal-agent challenges.

Many researchers have studied the consequences of monetary rewards and have suggested other forms of incentives. Bragelien (2001) has focused on pros and cons with performance based pay. He suggests that individual bonus programs can have positive effects if the results are easily measured and the job descriptions are straightforward. It can motivate to higher performance, and thereby support decentralization, feedback and risk-taking. Incentives will

thereby align the individual goals with shareholders' goals and solve some of the principal-agent dilemmas. However, some bonus schemes might neglect important tasks that are not easily measured, encourage focus on short-term results and discourage teamwork (ibid). Kohn (1993) argues that incentive plans only result in temporary compliance, because the internal commitment of the organization's members will not be influenced. He suggests compensating employees well, and applying other incentives than monetary rewards to gain high motivation (ibid). The Beyond Budgeting concept suggests several process principles when implementing incentive systems (Bognses, 2009). First of all, the concept suggests that all performance goals and rewards are based on relative performance. Second, the principles recommend no use of individual bonus rewards; only group, division or company rewards.

2.3.2 Fairness

When using incentives, especially monetary rewards, it is important to make them fair and justifiable. The motivation will decrease if the employee feels that the incentives are not fairly allocated. A person naturally compares his effort and related compensation with what he perceives of others effort and related compensation. The individual will generally not tolerate less relative compensation than his counterparts (Adams, 1965). Giraud et al. (2007) find that managers weigh fairness even higher than controllability when it comes to performance evaluation and incentives. Bragelien (2003) emphasizes that employees must understand the system as a positive element. If they perceive the system as unfair or incomprehensible they will lose motivation, commitment and respect for the company and the administration (ibid).

2.3.3 Evaluation criteria

Merchant and Van der Stede (2003) define several criteria for evaluating rewards and incentives systems. They argue that the performance dependent reward should be *valued* in order to provide motivation, and large enough or visible enough to have a strong *impact*. Further, the value of the reward and the reasons for receiving the reward should be *understood*. In addition, the reward should be *timely*; this means that the reward should be provided soon after the performance for optimal motivational effects. Lastly, the reward should be *cost efficient*. Some rewards are relatively expensive, some are not. To give an employee a monetary reward in a high-tax country will generate higher expenses for the company than gains for the employee. This is opposite of giving an employee recognition and

gratitude; the gains might be significant for the employee, but the cost for the company is almost zero.

2.4 Theoretical framework

Given the theoretical perspective presented in this chapter, a simple theoretical framework is suggested. This framework will act as a background for the empirical research design and information gathering. Furthermore, the framework will structure the analysis and discussions. See figure 2.2 for an illustration of the theoretical perspective presented in this chapter.

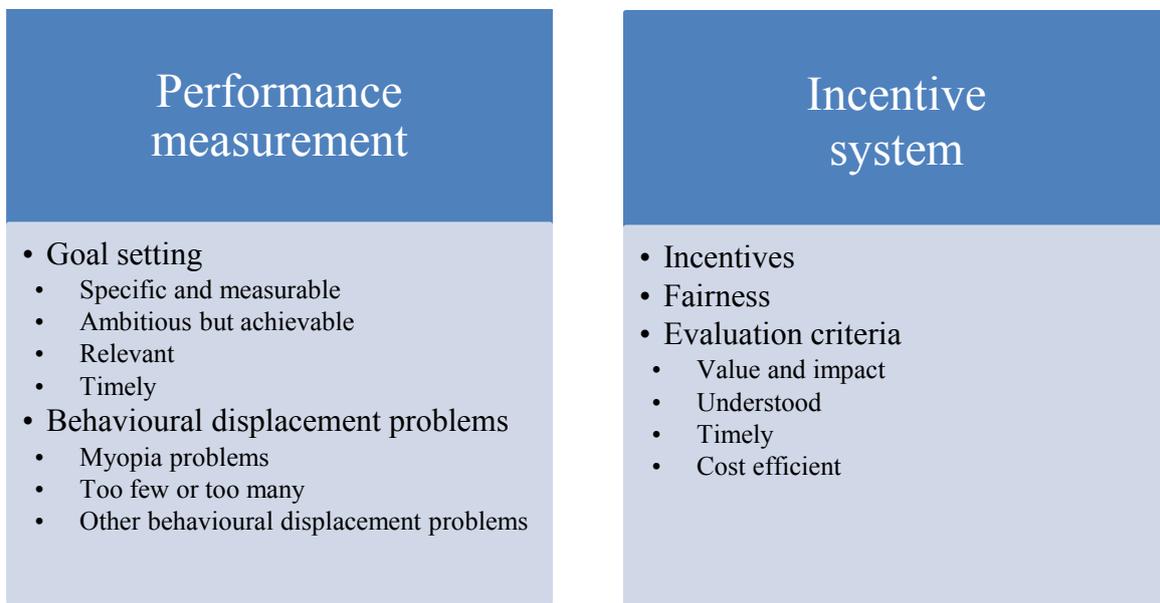


Figure 2.2: Theoretical perspective

A simplified model of this theoretical outline will act as the theoretical framework, and a guidance throughout chapter five; Analysis. See figure 2.3 for the theoretical framework.

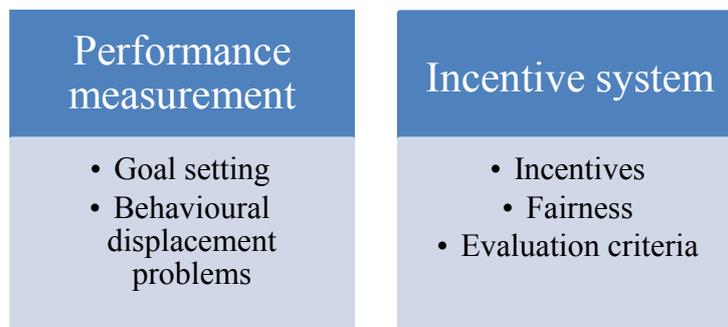


Figure 2.3: Theoretical framework

Chapter 3: Research methodology

This chapter describes research design and the information gathering techniques used in this study. The chapter also argues why these methods are chosen, and how the results are valid and reliable.

Methodology is a tool to describe reality (Jacobsen, 2005). Knowledge about research methodology is essential in order to identify if the results are the actual and real observations; the substantial explanations, or a consequence of the research in itself; methodological explanations (ibid). One classical example is the Hawthorne-effect, where correlation between lighting and productivity at a production plant was studied. The results showed that productivity increased with a change in the environment, no matter what kind of physical change. Hence, changes in productivity were a result of the test in itself, the observations and the attention given (Hellevik, 2009).

Another challenge of doing field studies lies within the debate of ontology, from Greek meaning *the science of the being*. Aristotle expressed his thinking of the *science of being qua being*, meaning “being in the capacity of being”. He set the first arguments for the philosophical ontological questions. One common question, relating to social and economical studies is; *are people rational?* This debate questions whether people act from a rational prioritisation of costs and benefits, in order to maximize their utility, or act from norms, values and emotions (Jacobsen, 2005).

Today social scientists identify several ontological approaches, or research philosophies. Saunders et al. (2003) broadly identify three research philosophies, depending on the way of viewing development of knowledge. First, positivism claims that general laws do exist in social science, as in physical science, and focuses on observations in order to discover and confirm these laws. Second, interpretivism argues that the social world is too complex to be defined entirely by laws and generalisations. Interpretivism argues that generalisation is of less importance due to the constantly changing environment, and that the aim is to discover the details in a situation in order to understand reality. Third, realism is the idea that large-scale social forces and laws do affect people without their necessarily awareness. Realism is to some degree similar to positivism; however, realism states that social science is not to be studied in the same manner as natural science (ibid). This study will use the view of

interpretivism, and thereby seek to understand the subjective reality of the research participants in order to understand their actions, intentions and their perceived reality.

3.1 Field of study

During the last decade management control practices have experienced large changes, and it is important to completely understand this development. The changes are to be recognized from both a theoretical and practical point of view. In order to understand the systems and processes, objective and clear information should be gathered. To understand and discuss the practical implications of the systems and methods, subjective research should be conducted.

As a research objective, the multinational energy company StatoilHydro is chosen. StatoilHydro is a Norwegian oil and gas company, with around 29.500 employees in 40 different countries (Annual and Sustainability Report, 2008). StatoilHydro works within a vast and complex number of business fields, such as oil and gas exploration, production and manufacturing, and technology and new energy. Furthermore, the organization consists of finance, staffs and services, and communications divisions (ibid). Operating in a large number of countries and within many different business fields, StatoilHydro is in need of a strong overview and management control system. However, decentralization, trust and flexibility are necessities in today's competitive and rapid changing marketplace. Great diversity in both operational areas and human capital makes decentralization a challenge. This will further create challenges for management control, because the actual value drivers, costs and revenues might be difficult to identify and control. Human capital at StatoilHydro is also highly diversified due to factors like difference in nationality, culture, educational background, level of experience and age.

The management control systems at StatoilHydro have developed dramatically during the last decade, with implementation of Balanced Scorecard, non-financial measures, the mindset of Beyond Budgeting and abandoning the budgets. Both the performance measurement and incentives systems have been changed during this period (Bogsnes, 2009). For this reason, and the argumentation above, StatoilHydro is ideal as a research objective for this study, in order to address the problem statement.

3.2 Research design

Research design is a detailed description of the structured process of the complete research methodology (Johannessen et al., 2009). When deciding on appropriate research design, it is important to bear in mind the problem statement of the study:

What is the relationship between performance measurement and incentives?

Understanding this relationship is a three-step approach. First, the development of management control systems, performance measurement and incentives the recent years must be studied. Second, the present performance measurement and incentive system must be described and throughout analysed. Third, conclusions of research findings and implications for management control practices must be discussed. This is a comprehensive study, which implies detailed knowledge and plans for research design. The following will explain different research design approaches, and argue what to apply to this study.

Two central dimensions are relevant for research and interview design; depth and breadth (Hellevik, 2009). These dimensions are related to two important issues in research design; the number of variables to study, and the number of units to study (ibid).

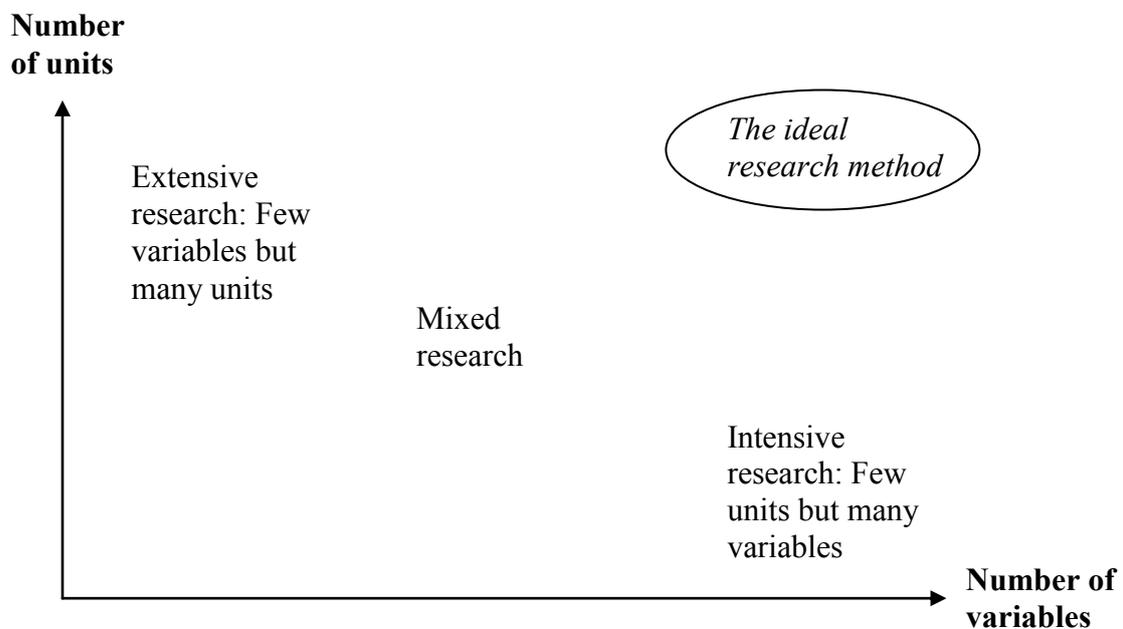


Figure 3.1: Research design dimensions

As illustrated in figure 3.1, the ideal research method is a vast number of variables studied on a vast number of units. However, this is often too extensive, due to constraints both in time and resources. Research design should therefore be extensive, mixed or intensive. The intensive design is in depth studies on a few units, the extensive design is general studies on many units and the mixed design is a mixture of the two. The research method used in this study is an intensive design. In order to maximize the findings of aspects and details about the phenomena, the intensive design is the most appropriate for the problem statement.

Furthermore, research design can be either inductive or deductive. The often traditional scientific approach is the deductive one, where a hypothesis or theoretical problem statement is examined. First the researcher formulates a hypothesis or a research question, then collects and analyses data, in order to confirm, disprove or modify the hypothesis (Saunders et al., 2003). Therefore, the deductive approach is preferred on issues already explored by researchers and literature. Opposite, the inductive approach gathers information first, without any initial hypothesis or perspectives of the results. Saunders et al. (ibid) describe the inductive method as a research approach involving the development of a theory as a result of the observation of empirical data. The information gathering approach used in this study is the deductive one. Hence, a problem statement will act as the fundamentals for theoretical perspective resulting in a theoretical framework; structuring information gathering and the further analysis of the results.

Saunders et al. (ibid) divide research design into three different main categories; exploratory, descriptive or explanatory. Descriptive studies aim to give a detailed explanation to a phenomena or situation. Explanatory studies are used if trying to explain the relationship between a number of variables. Exploratory design is used when the researcher aims for an overview and understanding of a topic, and is applicable if the problems are wide and unclear. For this study both the descriptive and the exploratory approach are being used. In order to answer the problem statement, one must first obtain a detailed understanding of the phenomena performance measurement and incentives and the developments, and the descriptive design is used. Secondly, in order to understand the relationship between the systems, their impact and consequences, the exploratory design is applied.

The information can further be gathered using qualitative or quantitative methods (Johannessen et al., 2009). Quantitative analyses are used for collecting a large number of

data, often statistics, and may therefore be appropriate for extensive research. Quantitative methods are surveys, reviews and other ways of gathering large amounts of statistics. Mathematical models and theories or hypothesis are used to evaluate the data collected, and the results are often presented in graphs, tables or charts. On the other hand, qualitative researchers aim to study social phenomena in depth. Qualitative analyses are used for understanding reason and behaviour, by asking *why* and *how*, not only *what*, *where* and *when* as compared to quantitative analyses. Qualitative research uses direct observations, in depth interviews, analysis of materials and participation in the setting as information gathering approaches (ibid). A qualitative design can in many situations be appropriate for intensive research.

In order to address the problem statement of this study, information will be gathered through available written information and in depth interviews with managers. To describe and understand the performance measurement and incentive processes, and their development over time, qualitative analyses are essential. To actually understand and further discuss the relationship, quantitative analyses would not be sufficient. Quantitative studies would neither be adequate for addressing the time-dimension of this research. Thus, this intensive research uses a qualitative and a deductive approach, based on the theoretical framework presented in chapter two.

3.3 Information gathering

Empirically, the problem statement will be addressed in two steps. First, performance measurement and incentive systems and their developments will be studied, using both available written information and in depth interviews. For the second part of the research, interviews with a number of objects will be conducted, trying to understand their interpretation and usage of the present performance measurement and incentive systems. Thus, a case study is appropriate, involving empirical research on a phenomenon within its real time context (Saunders et al., 2003).

The first stage of the study is an interpretation and discussion of performance measurement and incentives at StatoilHydro, and their developments over time. Secondary data; that is data originally gathered for another purpose (ibid), such as reports, journals, literature and other available information of the systems ought to be examined. In addition, primary data will be

examined, that is information gathered by the researcher for the purpose of this study. In depth interviews with three human resource managers will be carried out. These research objectives have been responsible for developing and implementing the different performance measures and incentive systems.

The second stage of the research is a deeper study on the systems impact and implementation, and the interpretation of the relationship between the two systems. In depth case study interviews with six managers participating in and using the present performance measurement and incentive systems will be conducted. The theoretical framework from chapter two will be the fundament for the interview guide. The primary data gathered will assist in understanding how systems work in practice and its impact and contribution. The systems relevance and importance will be discussed, in alignment with theory, in order to understand the consequences for management accounting practices.

3.3.1 Interview guides

The interviews in the project's first phase are individual face-to-face interviews with three human resource managers. The aim of these interviews is to understand the systems and their development. A semi-structured interview guide will be used; this is more of a conversation guide than a pre-structured questionnaire (Johannessen et al., 2009). The interview guide will contain the different themes and aspects to study, and "help-questions" to start the conversation and guide it on the right track. Open questions and follow-up questions are necessary for obtaining the detailed and specific information. The interviews are 35-40 minutes each and every interview will be recorded. See Appendix one for the first interview guide. Unfortunately, the interview guides are in Norwegian, due to the interviews being conducted using the participant's native tongue.

The second phase of interviews is individual face-to-face interviews with six managers using the performance measurement and incentive systems, and receiving financial bonuses. A structured interview guide will be used, with a precisely alignment to the theoretical framework. The questions in the interview guide will be pre-formulated and in a specific order. Each interview will be 25-30 minutes and will be recorded. See Appendix two for the second interview guide.

There are some important issues to consider when conducting face-to-face interviews (Jacobsen, 2005). First of all, one must establish an informal and relaxed, but still professional and trustful atmosphere. Second of all, one must start the conversation with relevant formalities, like introduction of persons, project, the aim of the research, how the interview will be conducted and some expectations for the conversation. Third of all, it is important to bear in mind that the interviewer is the listener and needs to comprehend all the information given, both from language, body-language and the extended meaning. Fourth of all, the interviewer must take accurate notes or record the complete interview. Finally, the interview must end professional and with an explanation of what happens next (ibid).

3.3.2 Evaluation of the results and methodology

The data evaluation process has been conducted as a three-step process. First of all, all interviews are recorded and formally written down. Second of all, a first impression and overview of each interview is formulated. Finally, the data is divided into different categories structured by the theoretical framework, and used as an outline for writing the analysis. It is important to underline that not all of the information gathered from the interviews is necessarily used in the analysis. Only the issues commented by several managers are discussed.

When conducting research evaluation and analysis one must bear in mind the issues of reliability and validity. Reliable research is important in order to have trust in the results (Jacobsen, 2005). This means that the analysis should give the same results at other occasions and that similar results would be reached by other observers. The results are valid if they explain what they intend to explain, with no underlying reasons (Saunders et al., 2003).

When addressing the subject of reliability, it is important to question whether the results are in fact the truth or a consequence of the research in itself. Saunders et al. (ibid) describe four threats to reliability; participant error, participant bias, observer error and observer bias. Participant error is related to the fact that the setting of the research possibly may influence the results. To make the participant comfortable and reduce the participant error every interview is conducted at the objects own office during normal working hours, using the participant's native tongue. Participant bias is a situation where the interview object only partly tells the truth or turns the information in a given direction. One argument against full

reliability is that people tend to give a positive impression of their organization and systems to external parties. This may result in the research becoming faulty, as people may fear that negative inputs during the interview may be used against them at a later point in time. This “whistleblower” effect is well known also outside of research situations, where employees fear to give information about problems due to the risk of personal repercussions. On the other hand, one may argue that respondents are more open to and honest with external parties, because they are encouraged to express their true feelings. The participants in this study have voluntarily contributed and that implies a general positive interest in the issues being studied. However, the interview guide has encouraged participants to elaborate on both positive and negative effects of the systems.

Further, Saunders et al. (ibid) also identify the issues of error and bias by the observer as threats to reliability. To reduce observer error every interview has been recorded and formally written before the actual analysis has been conducted. Observer bias is the threat that the researcher interprets the information in a certain way. It should be taken into consideration that these interviews have been conducted in Norwegian and translated into English, and might therefore be subject to bias by the researcher; who is also the translator.

To argue whether the research findings are valid, the discussion can be divided into internal and external validity (ibid). Internal validity refers to whether the findings are applicable to the entire organization or not. The interview objects used in this study are at vice president and senior vice president levels only; this will imply a high knowledge of the systems and their implications. However, nine interviews with eight managers are conducted; one might argue that this is an undersized number. However, using the interview guide, the same questions have been asked several interview objects. The results are only argued as valid if a majority of the participants has addressed the same issues. To account for internal validity, this study only argues what the challenges might be, not the extent of these challenges or if they in fact are actual problems for the entire organization.

Furthermore, the results are argued to have external validity, or generalisability, if they are applicable to other organizations (ibid). Using an existing theoretical perspective and building a theoretical framework, the findings will hopefully be of use to other larger companies implementing Beyond Budgeting principles, performance measurement and incentive systems.

Chapter 4: Empirics

The aim of this chapter is to present the empirical information necessary for the analysis; chapter five. This chapter will briefly describe the historical background of StatoilHydro, with the developments of Beyond Budgeting. In addition, today's management control system, including the performance measurement system, evaluation system and incentive system will be explained.

4.1 Historical background

StatoilHydro is a Norwegian energy company, with around 29,500 employees in 40 different countries (Annual and Sustainability Report, 2008). The parent company is StatoilHydro ASA with approximately 17,000 employees. StatoilHydro has a market value of more than NOK 500 billion, and is the world's largest offshore oil and gas company. StatoilHydro was formed after a merger between Statoil and Norsk Hydro's oil and gas divisions in 2007 (ibid). The Norwegian State Oil Company, Statoil, was established in 1972 as a private limited company owned by the Norwegian Government. The public limited company Statoil ASA was listed on both Oslo Stock Exchange and New York Stock Exchange in 2001. The present Chief Executive Officer is Helge Lund, appointed August 2004 (ibid).

StatoilHydro works within six business areas; Exploration & Production Norway, International Exploration & Production, Natural Gas, Manufacturing & Marketing, Projects and Technology & New Energy. In addition, the organizational chart includes staff and support divisions; Finance, Corporate Staffs & Services and Corporate Communication (The StatoilHydro Book, 2009). Furthermore, the organization is organized in a matrix structure divided into vertical assets such as Exploration & Production Norway, International Exploration & Production, Natural Gas and Manufacturing & Marketing, and horizontal processes such as Technology & New Energy, Human Resources and Global Business Services. These processes are functions that use expertise, capture learning, ensure quality and create synergies across the organization (ibid).

StatoilHydro has experienced a gradual development of the Beyond Budgeting mindset and a new performance management culture (Bogsnes, 2009). The process of abandoning budgets in Statoil started already in the 1990's. Management by objectives and key performance

indicators was common from the 1990's. The Beyond Budgeting philosophy and the new management control system were initiated in 2004 and fully implemented in the entire organization in 2008 (ibid). Development of the new holistic management control system has been a continuous process. Towards the full implementation of Beyond Budgeting, StatoilHydro has in recent years worked with implementation and education throughout the entire organization.

Additionally, the new performance management culture and system has a strong focus on values. The codes of conduct, individual performance standards, norms and values and sound business judgement are the fundament for leadership and performance in StatoilHydro. The corporate values and management system are clearly explained in the StatoilHydro Book (2009), available to all employees.

4.2 Management control systems in StatoilHydro

This chapter will briefly describe the present management control system in StatoilHydro. Core for the management system is the corporate values and The StatoilHydro Book, defining the standards, the systems and the expectations. The strategic planning process is the "Ambition to action" process; a dynamic tool for organizational long term and short term strategic planning. This process is further broken down into individual goals during the yearly "People@StatoilHydro" process. Every individual performance contract is described in the IT program "Management Information in StatoilHydro" (MIS). Performance evaluation of individuals is further linked to the incentives system (ibid).

4.2.1 Ambition to action

StatoilHydro defines performance as delivering on promises, outperforming peers and continuously improving (ibid). "Ambition to action" is StatoilHydro's integrated and dynamic strategy, target setting, planning, and execution and evaluation process. First of all, the process starts with ambitious strategy and target setting, defining strategic objectives, key performance indicators (KPIs) and KPI target. Second of all, the planning process is the realistic and expected outcome of actions and KPIs; the forecasts. Gaps between the ambitious strategy and the expected targets may occur. Third of all, the performance measurement system, called "People@StatoilHydro", includes personal goals and a holistic

performance evaluation. Lastly, the processes of dynamic execution, feedback and learning are conducted throughout the period. The “Ambition to action” process is a continuous, dynamic, forward-looking and action-oriented process, which translates long-term strategy into short-term strategic objectives, KPI targets and actions (ibid). The “Ambition to action” process is illustrated in figure 4.1.

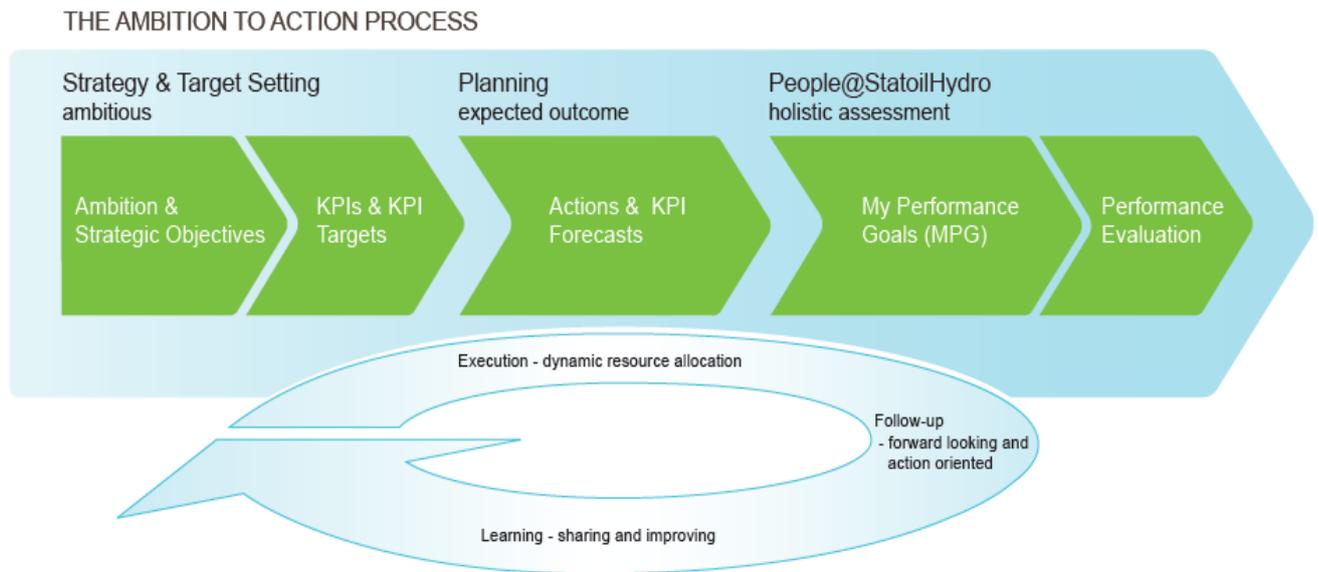


Figure 4.1: “Ambition to action” process in StatoilHydro

To balance financial and non-financial, and short-term and long-term focus, “Ambition to action” includes five delivery areas; People and Organization, Health, safety and environment (HSE), Operation, Market and Finance. Every unit in StatoilHydro has its own “Ambition to action” plan, in total around 700 plans. Every plan is divided into strategic objectives; “Where are we going?”, performance indicators; “How do we measure progress?” and actions; “How do we get there?”. Both KPIs and actions are constantly measured and monitored, and indicated green if on track, yellow if critical and red if off track. The “Ambition to action” plan is adjusted whenever needed, commonly several times a year. See figure 4.2 for illustration of an example of an “Ambition to action” process. The example is from the Manufacturing & Marketing division, and the unit of Retail in Latvia.

Ambition: Lean retailing beyond expectations - worth 3.1 MLVL EBIT

Strategic objectives	Performance indicators	Actions (top 5)
People and organisation		
Right people at the right positions Leadership based on Statoil values Ensure brand delivery in the customer interaction Accountable people and transparent culture	Sick leave HQ	➔ Implement RCC: implement on the job training to improve customer satisfaction (01.12.2006.)
	Staff turnover site	➔ Implement RCC: Implement e-recruitment tool to find the right people (01.04.2006.)
	HQ manning (FTE)	➔ Implement RCC Lean training at sites (31.12.2006.)
	WEOS Change Capability	➔ Implement new bonus system for sites to establish upselling culture and improve motivation (01.01.2006.)
WEOS Performance culture	➔ Implement RCC leadership program for top- and middle management (01.06.2006.)	
Health, safety and environment		
Zero harm to employees, customers and environment (LV) ISO Certification retained	SIF	➔ Implement RCC Food safety program (31.12.2006.)
	TRIF	➔ Implement RCC Contractor safety program (31.12.2006)
	Robberies	➔ Continuously implement Robbery prevention programm. Educate 100% of s/s staff trough robbery prevention programme. (31.12.2006.) ➔ Reduce fuel thefts to 370LVL/site (31.12.2006.) ➔ Implement RCC: Implement HSE on Site (31.12.2006)
Operation		
Create a lean operation structure One fuel concept (Price, network, product quality & brand, card rebates)	Market share petrol %	➔ Implement RCC LEAN program (31.12.2006.)
	Integrated fuel margin (LVL/l) R	➔ Network expansion - Franchise s/s - 9 franchise stations (31.12.2006.)
	Site labour cost % NF margin R	➔ FSS network expansion - 5 FSS (30.10.2006.)
	Retail fuel volume growth %	➔ Implement RCC Fuel category management (incl. best supply)
	New site months R	➔ LPG network expansion - 18 LPG outlets
Mystery shopper		
Market		
One store concept based on Scandinavian look and feel, driven by food to go and convenience solutions Customer driven category marketing targeting buying decision One B2C loyalty concept based on one card and rebate ladders Most efficient competitor in operating markets One strong 'out of the box' executing retail purchasing unit	Non-fuel sales growth % R	➔ Implement RCC test pilot store (31.12.2006)
	Shop margin %	➔ Shop pricing strategy to ensure +19% non fuel growth (1.03.2006)
	Customer satisfaction	➔ Implement RCC rollout relevant modules of the RCC store development program (hot beverage/hot food) (31.12.2006) ➔ B2B sales goals + 10% volume increase (31.12.2006) ➔ Loyalty programm implementation to increase volume on B2C by 10% (31.12.2006)
Finance		
EBIT2 2007 of LVL 3.5 million Improved ROACE through program and capital management Long term IT strategy in place	EBIT (LVL) R	➔ Implement RCC successful SOX implementation and line management take-over (31/03/2006)
	Transformation effect (LVL) R	➔ IT cost and project control to develop stable IT environment (30/04/2006)
	Total cost % total income	➔ Bad debt exposure under 80 KLVL

Figure 4.2: “Ambition to action” plan – Retail Latvia

This management control system communicates the Beyond Budgeting approach, and several of the 12 principles identified by the Beyond Budgeting Roundtable (2009). The leadership principles of decentralization, autonomy, responsibility, transparency and governance are to various degrees addressed in the new system. Furthermore, the fundamentals of Beyond Budgeting contain six principles for alignment of management processes with leadership actions. Number one, Beyond Budgeting suggests setting relative goals, not fixed contracts. The idea behind KPI's and actions in “Ambition to action” is creating them relative. StatoilHydro also use benchmarks against competitors when setting performance goals. Number two, rewards should be based on shared success on relative performance. StatoilHydro uses relative performance targets to a large extent but shared goals to a smaller degree. Additionally, the rewards are mostly individual and tied to individual performance. Number three, planning is to be a continuous and inclusive process. This is very much addressed in the dynamic and holistic “Ambition to action” process. Number four, control should be made against relative indicators and trends. This is very much secured by the dynamics and flexibility in the system. Number five, resources are to be available as needed. This issue is also addressed by the “Ambition to action” process, with dynamic resource allocation throughout the period. Number six, Beyond Budgeting suggests dynamic coordination. This issue may also be addressed by the dynamics in the management system.

4.2.2 People@StatoilHydro

“People@StatoilHydro” is the process ensuring alignment between “Ambition to action” and individual targets and performance. In addition, the corporate vision declares that behaviour is as important as delivery. Consequently, every employee is measured on delivery of “Ambition to action” goals and how they deliver; their behaviour. Behaviour targets are based on formal feedback from the co-worker conversation “The People@StatoilHydro dialogue”. This dialogue is based on the work environment and value surveys; Even Stronger Values (ESV) and Global People Survey (GPS), in addition to day-to-day observations from leaders and colleagues (The StatoilHydro Book, 2009). Targets are documented in the IT-system “Management Information in StatoilHydro” (MIS). Performance evaluation is conducted yearly by the manager, and they are expected to make decisions based on values, principles and policies, decision criteria and authorities, Ambition to action and a sound business judgment (ibid).

The yearly “People@StatoilHydro” process may be described as a traditional annual management control process (Nyland and Østergren, 2008). The first step is strategic planning, consisting of the Ambition to action process. The second step is setting the individual goals. The third step is performance measurement, and the last one evaluation and incentives, as illustrated in figure 4.3.

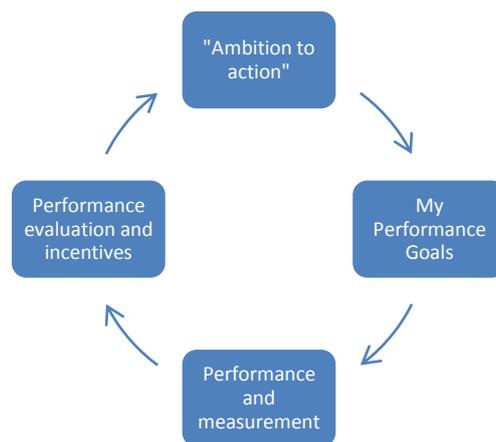


Figure 4.3: Traditional management control process

However, there are some differences between the traditional description of the management control process and the “People@StatoilHydro” process. First of all, all employees are supposed to contribute in their own personal goal setting process; coming up with suggestions

to performance goals and discussing them with their co-workers and manager. Second of all, the Balanced Scorecard approach includes measures on both KPI's and actions, so the performance goals are both in relation to the critical success factors and the actions necessary to get there. Third, the performance measures and measurement are subject to re-evaluation every six months and feedback throughout the year. Fourth, the performance assessment is a subjective evaluation of delivery, behaviour and values. In addition, StatoilHydro has recently worked to get the performance measurement more specific, concrete, measurable and dynamic, as well as conducting throughout coaching on how to set behavioural goals.

4.2.3 Performance evaluation and incentive system

The incentives system at StatoilHydro is based on the yearly performance evaluation. Employees have KPI's and action-measures on some or all of the delivery perspectives. In addition they have goals on behaviour and evaluation of their behaviour according to the organizational values. Every year work environment questionnaires, self-assessments, 360-, 180- and 90 degrees evaluations of every employee are conducted.

The behaviour evaluations are based on the corporate values; Courageous, Open, Hands-on and Caring. For courageous employees are evaluated on their ability to be imaginative, ambitious, creative, identify opportunities and challenges, make a clear demand on each other and understand and manage risks. For the value openness employees are expected to be truthful, curious, act with integrity, work together, share experiences, communicating precisely and bring up ethical issues and challenges. Furthermore, employees are to be hands-on, defined by delivery on promises, demonstrate commercial awareness and customer orientation, strive for simplification, focus on value-adding activities, act decisively, allow dedication and pay attention to important details. Finally, employees are expected to be caring, which means cause zero harm, reduce negative impact on the environment, act within the law, demonstrate social responsibility, respect the individual, help others to succeed and contribute to a positive working environment (The StatoilHydro Book, 2009).

The results on delivery and behaviour measures are further put through a subjective evaluation by the manager and the manager's manager, giving the final score in a matrix. Delivery and behaviour is equally weighted 50/50, giving the employee the final grade; as illustrated in figure 4.4.

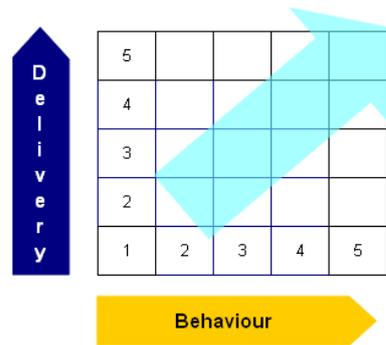


Figure 4.4: Performance evaluation matrix

StatoilHydro uses different methods of performance based incentives. About 1000 leaders and managers in the parent company StatoilHydro ASA are included in the Annual Variable Pay Scheme, giving them an individual financial bonus based on their performance. The bonus payout is maximum 50% of base salary for the CEO, 40% for executive directors, 27.5% for first line of managers and 17.5% on the next level. The performance score on the delivery and behaviour matrix gives the fundamentals for the bonus payout. To get the maximum payout one needs to have a five-five score in performance. Every score on the matrix has a range of possible bonus payouts, depending on the position of the employee. So, for instance a three-four performance may give 10-15% possible bonus payout. Then it is up to the manager to give a subjective performance evaluation to decide the final percentage bonus payout.

In addition, every employee is a part of the overall corporate bonus scheme, which is up to 5% of base salary depending on overall company performance. This corporate bonus is often divided into a company element and a business unit element, depending on business unit performance. Furthermore, the performance ranking is subject to changes in the base salary for every employee in the organization. The yearly collective wage settlement results in salary changes, which depends on the employees individual performance score. Additionally, the performance evaluation and score is frequently used in career plans and developments, and possibilities for new career opportunities in the organization.

The financial bonus system described here is used in StatoilHydro ASA. Although every subsidiary uses the StatoilHydro Book and the same management system, many use different incentive systems and many use individual bonuses to a larger extent than StatoilHydro ASA. Some use performance dependent pay for 80-90% of their employees. However, this study will concentrate on the incentive system used in StatoilHydro ASA.

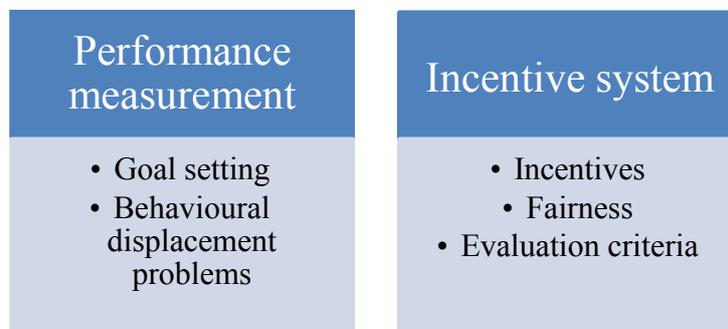
Chapter 5: Analysis

The aim of this analysis is to address the problem statement of this study:

What is the relationship between performance measurement and incentives?

Especially essential for this chapter is the information presented in chapter four; Empirics and chapter two; Theoretical perspective. In order to answer the problem statement, this analysis will be divided into four parts. Firstly, the *developments of management control systems* in StatoilHydro will be discussed, focusing on managers' experiences of these developments. Secondly, issues in *performance measurement* will be dealt with, including a conclusion. Thirdly, the *incentive system* connected to the performance measurement system will be examined, also including a short conclusion. And lastly, the final conclusion will include a discussion of the implications of performance measurement and incentives for management control and Beyond Budgeting practices.

This chapter will use the first part as a fundament; describing developments of management control systems. The rest of the chapter will use the theoretical framework introduced in chapter two as a structure for the discussion.



5.1 *Developments of management control systems*

Operating in a vast number of countries and within many different business fields, StatoilHydro is in need of a strong overview and management control system. Nevertheless, decentralization, trust and flexibility are necessities in today's competitive and rapidly changing marketplace. However, great diversity in operations, markets and human capital makes decentralization at StatoilHydro a challenge.

StatoilHydro has experienced a gradual development of the Beyond Budgeting mindset and a new performance management culture. The process of abandoning budgets in Statoil started already in the 1990's. However, the progress towards the beginning of a Beyond Budgeting philosophy in 2004 has been different throughout the organization. Some divisions used budget as a main control system the entire period, while others never used budgets as a performance management tool to a greater extent. Many of today's leaders in StatoilHydro confirm a previous focus on budgets and financial measures; here are some of their statements:

Before Beyond Budgeting we focused mainly on pure delivery goals; many business unit leaders had only accounting based measures as individual targets.

We had a much stronger focus on financial figures and a stronger budget mindset earlier.

Management by objectives and key performance indicators was common from the 1990's, although a majority of the divisions used a combination of budgets and the Balanced Scorecard. The leaders at StatoilHydro have experienced the development differently. Some say they used key performance indicators and a Balanced Scorecard approach throughout the period, while others did not. One vice president comments the fact that the requirements and coaching of the systems were not satisfactory:

We experienced poor coaching and follow-up against measures and KPI's, because the system was too random. We did not have a system or a structure, and it was not compulsory to use these measures. Some used KPI's and performance measures, some did not, some did not care and nobody remarked that.

One human resource manager explains that the system used today is very much similar to a system they used in her department already in 1995. She also comments that this system was available to many divisions even though it was not compulsory:

In 1995 or 96 we used a system not very different from the one we have today. We measured on delivery and behaviour, we used 360 degrees evaluations, 180 degrees and 90 degrees, and we used a performance scale from one to six. We used this system although it was not mandatory. But some years later the system was slipping. But when Helge Lund started as CEO in 2004 and he paid very much attention to the concept of values. He initiated the performance management system which has developed from 2004 to what it is today.

Studying the historical development of the performance culture in StatoilHydro, one of the most disciplinary events was the listing on the Oslo and New York Stock Exchanges. As commented by one of the senior vice presidents:

The ground breaking event for performance management was the listing; we got a marked which controlled all of our actions and decisions. We were no longer owned by the government (...) there were no excuses anymore.

Consequently, the new performance management culture and system had a strong focus on values. The codes of conduct in addition to the individual performance standards, norms and values, were supposed to be clearly communicated in the management control system. As illustrated by one of the senior vice presidents, the importance of clear, communicated and identified values are more important today than ever:

We shall develop a strong value based performance culture. Because there are only a couple of things that can totally destroy this company; a serious HSE accident or a case of corruption.

Another vice president explains the reasons for the strong focus on values and behaviour:

We are a global organization, and we need a set of ground rules when it comes to values and behaviours reflecting how we act and who we are. Or else we might risk that individuals, in craving to deliver high results, can ruin the entire organization; on issues such as HSE, integrity, ethics or corruption.

The strong focus on behaviour is based on the beliefs that superior results are dependent on values, actions and conduct. Consequently, delivery and behaviour are closely connected and should thereby also be closely connected in the management control system. As commented by one human resource manager:

It is obvious that conduct and behaviours have a strong connection to results, they are very much integrated. The quality of your delivery results is very much dependent on your personal values and behaviour. A superior result requires a strong relationship between delivery and behaviour.

As explained in chapter four, the Beyond Budgeting approach was fully implemented in the entire organization in 2008. One manager expresses the Beyond Budgeting approach to be more strategically focused and dynamic:

After learning about the Beyond Budgeting philosophy we have learned to make changes continuously. It has been hard for some people to give up something as simple and easy as a budget, and to start thinking about long term strategic goals and the actions necessary to get there.

This system is a tool working towards a high degree of decentralization. As discussed in theory and literature (Wallander, 1999; Hope and Fraser, 2003) decentralization and trust is an important factor in coping with the issues of uncertainty and adjusting to the changing business environment. However, this heavily decentralization of important tasks as decision making, resource allocation, investment opportunities and performance management may also be a risk factor. This is commented by several vice presidents, here expressed by one of them:

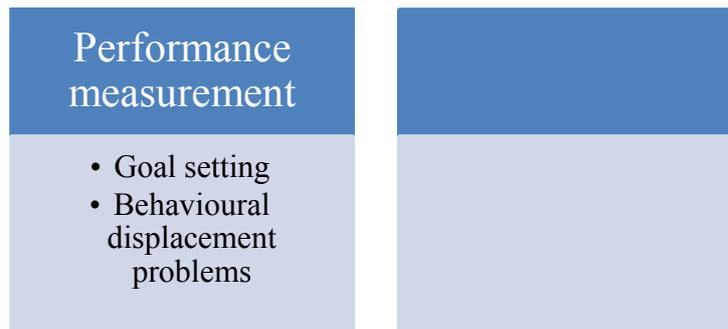
There are many challenges. This is a huge organization, and the most important tool is leaders at different levels, and it is a long way out to the last leader. They really need to identify themselves with this system, take the necessary leadership role and learn how to be a good leader. This is most certainly a challenge.

One senior vice president comments that he experiences a difficulty to ensure high quality and control throughout the organization and with all the different “Ambition to action” plans:

Trust is delegated far out in the organization. And when we start to get hundreds and thousands of “Ambition to action”, some of them are really bad and some are extremely good. We just have to live with this. We need good leadership in every part. This is a chance we take; this is trust.

5.2 Performance measurement

When discussing issues in performance measurement it is central to study two different aspects. Firstly, the *goal setting* will be examined, including formulation and relevance of the performance measures. Secondly, the employee’s reaction to the measures will be discussed, in order to identify if the system might encourage in any *behavioural displacement problems*. Lastly, this chapter will include a conclusion of the most important issues in performance measurement using the characteristics of Friestad (2008). For structure of this chapter, please see the illustration of the theoretical framework below.



5.2.1 Goal setting

Goal setting is an important part of performance measurement. The actual performance measures need to be understood and identified by the employee. Being a part of the goal setting process is a good way of assuring identification and commitment to the goals, as well as performance (Lock and Latham, 2002). All employees in StatoilHydro are, to some degree, included in their own goal setting process. Further, a human resource manager describes the importance of clear expectation setting and a structured approach to goal setting and feedback:

To me, it is extremely important to make things as clear as possible to the employees about what is expected from them. (...) We have a very transparent system with a structured method for goal setting and feedback.

However, goal setting is always an issue in performance management. Challenging issues are often goal formulation, accounting for uncertainty and include a clear connection to overall business strategy. This is especially challenging in knowledge intensive organizations where multitasking, independent decision-making and creativity are key factors. As commented by one president:

There are of course weaknesses in this system, one being that we could actually use the wrong indicators. So the system will never be greater than the quality we build in.

The next chapters will include a careful discussion of goal setting, structured after the SMART criteria (Gardiner, 2005; Shields, 2007). The suggestion is to make performance measures SMART, in StatoilHydro these are the personalized key performance indicators and action objectives in the “People@StatoilHydro” system. One section will discuss *specific* and *measurable* goals, one will discuss *ambitious* but *achievable* goals, one *relevant* goals and one *timely* goals.

Goals should be specific and measurable

Setting specific goals is claimed to be one of the most important factors of goal setting (Lock and Latham, 1990, 2002). The measures should be clear, understandable and it should be obvious to everyone what is needed to perform. Combining measures on actions with measures on key performance indicators; the “Ambition to action” process is contributing to making specific goals. Using the Balanced Scorecard approach, every employee can understand what is expected and how to perform. The delivery goals are to a large degree clear, specific and measurable. For instance, milestone goals are commonly used in projects; they are both specific and measurable.

However, when it comes to behaviour goals the question whether they are specific and measurable is more difficult to answer. When using corporate values as performance measures it might be unclear what is needed to perform and it might not be measurable. The evaluation is based on subjective criteria from the manager, and the measurement might be difficult for the employee to comprehend. Several managers find it extremely difficult to set accurate behaviour goals and even more difficult to evaluate the results. One human resource executive confirms that many managers find it difficult to set appropriate behavioural goals:

Even though we have run this system for many years now, we experienced that when we tested managers last year, many of them did not understand that behaviour is about more than just being a kind and polite person. Behaviour is actually about what is necessary for delivery on the promised results. Now we have conducted training of 430 managers on how to set correct behaviour goals and how to do follow ups and evaluation on behaviour. (...) So if something is worrying me it is too little precision and quality in the behaviour goals.

Another vice president confirms the difficulty of defining measurable behaviour goals. In addition he finds it even more difficult to do the actual performance evaluation with all the information available:

It [behavioural goals] is much more challenging to measure! You are supposed to be caring, hands on, truthful, professional and much more, and you are supposed to measure it on the same basis as delivery. When you at the end of the year have a stack of 50 pages with analysis, feedback, work environment surveys, self assessments and others evaluations, it gets much more complicated! It is much less complicated to

discuss delivery; did you deliver on your production target or not? Did you get this deal signed or not? And so on. Behaviour is complicated to measure.

However, behavioural goals are still considered a good way to account for values and ethics in the performance measurement system. Despite these challenges, StatoilHydro continues to use both delivery and behavioural measures. However, they focus on education and new approaches to setting the right goals, and making them specific and measurable. One department has addressed the challenge by connecting every behaviour goal to a delivery goal:

We set the behaviour goals in relation to the delivery goals. For instance, if my delivery goal is to launch a new management tool, my behaviour goals should be the behaviour needed to deliver that tool. This can be to cooperate with specific people, be committed to the project, and so on.

Goals should be ambitious but achievable

In order to get employees to strive for superior results, goals need to be ambitious (Lock and Latham, 1990, 2002). However, they must still be achievable. StatoilHydro has recently attempted to get the goals to be more ambitious. Nevertheless, there is still a challenge to make the goals fully achievable and to account for the controllability principle (Merchant et al., 1987). This is partly due to the fact that many measures are collective among managers; it is also due to the challenges with uncertainty.

As commented by one vice president, it is crucial to balance between ambitious and realistic performance goals. He feels that one demanding part of Beyond Budgeting is setting ambitious targets for employees to strive for:

The stretch target gives incentives to perform up to a given point; this is the point where people stop believing in their target. Because, if you introduce distress and nervousness; people will feel a lack of motivation. This is a challenging part of Beyond Budgeting.

With the philosophy of Beyond Budgeting and the method of subjective performance evaluation on delivery, behaviour and values, it may be easier to set ambitious goals. A project manager in StatoilHydro feels that the system encourages ambitious goals:

With a Beyond Budgeting mindset it is easier to set ambitious goals. People were too careful with goal setting before, and reaching the goals was most important, not

whether they were ambitious or not. Today it is more accepted to set an ambitious target and fail, than to set an easy target and succeed.

However, in today's performance measurement model it is very common that managers set their own goals and actions. This may encourage ambitious goals and high performance (Lock and Latham, 2002). However, it may also be a danger if people have low self-efficiency and use this opportunity to set easy goals (ibid). This is especially dangerous when measures are strongly tied to incentives, as is the case for many managers in StatoilHydro. Thus, it is important that the goals are approved and secured by the next level manager. Today, individual goals are subject to discussion, but managers do set their own goals to a large degree. Thereby, it might be a problem to fully secure all measures and ensure that they are ambitious. When being asked whether their goals suit themselves and their job, managers answer:

Of course, I made them myself!

Yes, absolutely. It is very much because I have to a great extent formulated them myself, being approved by my manager of course. I take my job description as a starting point, and make my goals what I think are the key success factors for delivery.

In order for the goals to be achievable, the employees need to be in control of the performance measures. To be accountable one must remember the controllability principle (Merchant et al., 1987). An employee should not be held accountable for factors he cannot sufficiently control. When being part of a staff or group in StatoilHydro it is common to have shared goals with other staff members. This may be a good idea in order to account for the teamwork and team success. However, it may be problematic when performance measurement is subject to individual evaluation and incentives. Neglecting the controllability principle may be a source of conflict and injustice, when employees feel their performance measures are outside their control area. When asked if goals are personal one human resource manager responded:

I have exactly the same KPI's as my boss. Because I am a part of the staff and I am collectively responsible as a part of the management group.

Having collective responsibility and team goals are a good initiative to support teamwork, but when the performance contract is subject to individual evaluation and incentives it may be a challenge. The exact opposite issue is found at lower levels in the organization; the

performance measurement is individual, but the incentive system is to a larger degree collective.

Furthermore, when addressing the issue of achievable goals, the problems of uncertainty arise. In a diverse organization like StatoilHydro, operating in a highly uncertain environment, setting the right goals are extremely difficult. Without exact measurable goals the employees will not know how to focus their attention and work in the right direction. However, fixed performance goals may be a great challenge in the volatile marketplace. One senior vice president describes the situation with uncontrollability as follows:

In a dynamic world you just do not know; it is not the certainty that runs the company. We need leaders who are capable of taking the right actions along the way. If things change, externally or internally, we need to take new actions and maybe prioritize differently according to the world we live in.

Merchant and Van der Stede (2003) suggest changing the measures after the measurement period to account for uncontrollable factors. The Beyond Budgeting Roundtable (2009) suggests using relative goals only. StatoilHydro solves some of the issues with uncertainty with three approaches. First, they use relative goals to a large extent. Second, the goals can be subject to changes during the measurement period. Third, they apply a subjective evaluation at the end of the year to whether the measures were the right ones and ambitious enough. One financial manager describes the relative goals as a profitable way of doing business:

The way we can define our goals as project targets, with routine updates and no static goals, is very good. If you set all your goals static in the beginning of the year and an opportunity arises, you might say no to that opportunity because it is not in your measures to prioritize.

On the other hand, he describes relative and flexible performance targets as a challenge when it comes to performance evaluation:

However, the flexible targets are a very demanding part of Beyond Budgeting. Especially in parts of the organization with powerful incentives, the relative goals are extremely difficult. There might be situations where the employee and manager disagree on the performance, because the goals are flexible and may have been changed or the stretch target moved. So you can see why some co-worker conversations can be very difficult.

Another method StatoilHydro uses to manage uncertainty is changing the performance measures throughout the year. One vice president claims that her division changes or revises the goals up to six times a year:

It is a connection here, when we update “Ambition to action”, maybe four to six times a year, all the individual goals are also updated. Some changes are discussed in the mid-year co-worker conversation, some are just continuously changed.

An interesting dilemma in performance management is the issue of dynamics when addressing the problems of uncertainty. The management system “Ambition to action” is a dynamic and strategically focused method used to profitably manage the organization and operations in today’s uncertain environment. The system is based on a dynamic mindset with dynamic resource allocation and profit maximisation. The ideas are that resources should be allocated where they are needed the most, in order to maximize shareholder value. It is clear that business success is highly dependent on the oil prices, which are extremely volatile. The strategic management model “Ambition to action” is therefore regarded as a dynamic tool. However, many managers perceive the performance measurement system, “People@StatoilHydro”, as a relatively static tool. Individual goals are set for one year at a time and may possibly be subject to changes during the year, as commented by the manager above. Nevertheless, many managers claim that goals seldom change during the year and that the system is more static than dynamic. The performance measurement system is by some managers regarded almost as a static traditional management control process. One senior vice president comments:

I have my personal goals, but they are seldom appropriate because my focus and what I work with change faster than what the system can comprehend. It is obvious that the system with personal goals works best in a steady operational situation; where you can set concrete goals January 1st, and where you, your job and your goals are still there and are relevant, December 31st. (...) So, we have today an activity based management system, “Ambition to action”, which is much more dynamic than the “People@StatoilHydro” system, which handles individual goals.

As pointed out in the statement, it is difficult to account for dynamics in the performance measurement system. When it comes to resource allocation, it may be relatively easy to make financial resources dynamic. However, it may be a challenge to make human resources as dynamic as the financial. This may be one reason why dynamics in performance measurement

is a challenge. Two senior vice presidents comment on the issue of dynamic human resource allocation:

Dynamics in the company is; "postpone this and stop that" if the oil prices are reduced, so the activities are slowed down. This system ["Ambition to action"] is easily made dynamic by changing strategic objectives and so on. But the problem is, and it will be interesting to see 50 people working on one project, and 70 people on another project; what happens to them?(...) It is a challenge to move people from what was important yesterday to what is important today. It is a question whether the people dimension is suitable for these types of changes.

I think the challenges are outside the systems. Because when the strategic focus changes, the resource allocation needs to change accordingly. So we need dynamics in the population equal to the dynamics in the systems.

It is also interesting to study the dilemma of constant changes in the systems. The systems and their contents change very often, faster than people sometimes can understand and comprehend. System designers work full time to improve the systems and processes, and there might be a conflict because the users of the systems cannot grasp the constant new information. This is commented by one vice president:

I believe our systems are good, but I also believe that the excitement to improve them often is higher than the speed with which people can digest them. So it will be a constant battle between the users and the people that work with system design and development on a daily basis. The speed of implementation and comprehension is often slower than you would think.

Goals should be relevant

In order to be relevant, goals should reflect the overall business strategy (Merchant and Van der Stede, 2003). Traditional accounting measures of performance are not perfect indicators of value creation. Today StatoilHydro uses a Balanced Scorecard approach with performance measures on several aspects of value creation, both lead and lag indicators. One human resource manager explains the previous focus on traditional accounting measures, and the related weaknesses:

Managers were to some degree measured against their budgets; if they managed to stay inside the lines. But there were great differences in the different parts of the

organization; some had only cost budgets, some had revenue or profit budgets. (...) Investments yielding revenue in ten to fifteen years could be overlooked due to the short term performance measures and budgets. The system was very rigid; it was hard to see the whole picture.

Dynamic measures are also an issue in goal relevance. If the environment changes and measures no longer are relevant, managers need to take actions to change the measures and the priorities. One vice president comments on the importance of dynamics and changing the measures whenever needed:

I am afraid that there are too little precision and quality in the goals, and too little flexibility during the year to delete what is no longer relevant and include new measures. (...) Further, it is important to secure alignment between the department overall goals and the individual goals, but at the same time make them flexible and give freedom to act properly in the marketplace.

Another issue of goal relevance is the behaviour goals. Every employee is measured according to the four organizational values, even though some values are more important in some departments than others. The managers at StatoilHydro have strong thoughts about measuring on values. Some claim that there is too much focus on values in the system, without linking it to performance and business strategy. Here are some of their statements:

I believe that there are other things than values we can measure behaviour against. How to run a company and to be a good leader is about more than values only. StatoilHydro is not run using values only. Values are something everyone has, but how we manage the organization is about a lot more. (...) I think this system is too HR focused. A leadership position includes much more than HR.

It can be dangerous to treat everyone the same, I believe that some jobs demand different things than others. For instance courageous, which is one value, is more important in some situations than in others, the same with caring.

If you start messing with human behaviour, attitudes and mindset when making ground rules, you are back to kindergarten and primary school behaviour rules. Values are fundamentals in people; they are things that do not change over time. So

this is, in one way, only a set of behavioural rules for how to behave as a leader in StatoilHydro.

One challenge when implementing a performance management system is the organizational structure. The overall strategy, the business unit measures and the individual measures need to support the structure. StatoilHydro is organized in a matrix structure with vertical assets and horizontal processes for expertise, learning, quality and synergies. However, the performance measurement is a rather hierarchic vertical process, and it may be a challenge securing high performance in the horizontal processes. At higher organizational levels these issues are handled with common goals within a staff team, nevertheless the measurement system needs to be accommodated by the performance evaluation and incentive systems. As discussed earlier, performance evaluation and incentives are fully individual in StatoilHydro; common goals might therefore be a challenge. One human resource manager describes how the performance measurement system supports the matrix structure at the higher managerial levels:

At the highest management level we often have the same indicators. My boss has the same indicators as the business unit, and I have some of her indicators. So, common performance indicators are one way to account for the matrix and the mutual interdependencies.

Another manager claims that the horizontal processes are to some degree neglected in the performance measurement system, and he suggests sharing targets across divisions:

One thing we can do, and that we should definitely try to do, is to crosslink targets between different departments that are dependent on each other, so that they share the goals. Because in this company there are units that deliver and units that support the delivery, and there is an integrated relationship. For instance, in this company projects are delivered by the division called pro, for projects, and they are evaluated on project costs and milestones. However, the actual production site producing the delivery is not evaluated on costs or milestones. They are evaluated on HSE and quality. This is far from perfect, and it makes conflicting interests between intelligent people.

Another vice president says that common goals horizontally are used to some degree. Nevertheless, one issue is that these processes are not sufficiently followed up. This might be due to the unclear link to evaluation and incentive systems. The vice president comments:

The interesting thing is, and in my opinion we are lagging behind, it is to set common goals across the organization. It does exist, but there is no follow-up when you have a matrix-structure and shall make it work, and you have an incentive system. We started out with individual bonuses in addition to base salary, and now we have a corporate element and a unit element on division level. When the organization has so much common cross functional dependencies, we start asking questions about this unit element. Because when you have mechanisms that do not work together, you will not succeed. Of course, you need to make the successful mechanisms support the overall strategy, and when you design an organization to work across functions you need to measure accordingly. I don't think we are good enough at this.

Goals should be time based

Important for goal setting is clearly defined timeframes, to identify when the results are required and make the planning process possible (Gardiner, 2005; Shileds, 2007). All performance measures at StatoilHydro are set on a one-year basis, with evaluation after one year. In this manner they are clearly time based. However, many may argue whether a one-year basis for performance goals is actually appropriate in every situation. StatoilHydro is a large and diverse organization with great differences in operations, markets and projects. It may be suitable with longer term goals in some departments. For instance, in exploration and research and development projects it may be suitable with timeframes of two or three years for the performance measures. On the opposite, some projects may gain from shorter term goals, for instance three months milestone goals. This is also a question of dynamics; it is clearly not fully dynamic to use one-year measures only.

5.2.2 Behavioural displacement problems

Behavioural displacement problems are common management control side effects. These problems occur when the management control system produces or encourages behaviours that are not consistent with the organization's objectives or strategy (Merchant and Van der Stede, 2003). This chapter will focus on possible behavioural issues caused by the performance

measurement system; *myopia problems*, challenges with *too few or too many* performance measures and *other behavioural displacement problems*.

Myopia problems

One common issue of performance measurement is short-sightedness, or myopia. This is a behavioural displacement problem that makes managers excessively short-term oriented (Merchant, 1985). Therefore it is important to include both long term and short term measures in the set of performance targets. This issue may to some degree be solved today, due to the Balanced Scorecard approach to delivery goals in addition to a strong focus on behaviour and values. Earlier, the system might have favoured short-term profit maximization and encouraged managers to focus on short-term profits, due to budgets and other short term accounting based performance measures. However, it is still a challenge today to make goals account for long-term strategy, and many managers may find it easier to set short term focused goals. As commented by one senior vice president:

I believe that today's Balanced Scorecard has a stronger focus on short term operational aspects than on the longer term strategic aspects. (...) It is much easier to be concrete, to say that the sales target is seven million and the margin should be X. It is easy to only focus on controllable targets, and that is reasonable because we cannot control the oil price or the market price. But what if the total result is negative, but you still delivered what you were supposed to. Is the performance outstanding? According to the performance measurement system it actually is!

The statement describes the difficulties with setting long-term strategic goals, and many managers will find it easier to continue setting short-term accounting based measures only. However, results from these will not reflect overall business performance. Therefore, it is important to have a balance between lead and lag key performance indicators and action measures, on both short and longer term.

Too few or too many

Behavioural displacement problems may occur in relation to the number of performance measures used. Theory and literature have debated this topic. Some suggest a larger number of performance measures, like the Balanced Scorecard (Kaplan and Norton, 1992, 1996) and some suggest a focused and limited set of measures (Malina and Selto, 2001).

An issue with too few performance measures is too much focus on the actual target. Today this problem may be solved by using the Balanced Scorecard approach for delivery goals, but it might have been a problem before the implementations of Beyond Budgeting. However, there might still be issues if employees are too focused on the key performance indicators. Several human resource managers state the importance of defining specific actions with measures connected to each key performance indicator. One manager emphasizes that these measures are only indicators of performance and that one should not be overly focused on the target:

One weakness with this system can be that people are too concerned with the KPI targets, without it being more than just an indicator.

The issue of too few performance measures seems to be solved with use of the Balanced Scorecard and a combination of delivery and behavioural goals; as long as the quality and use of action measures, as well as key performance indicators are good. Another more serious issue may be the use of too many performance measures. One human resource manager describes the goal setting as follows:

There are many goals in total, because we have delivery goals on several aspects, it is personnel and organization, HSE, the actual delivery in the unit, collaboration with the market, and finance, so it is five areas. So you have at least 12-13 goals on delivery that you are supposed to delegate to your co-workers.

In addition to the delivery goals, every individual has behavioural goals. A challenge is motivation and commitment to the goals when an individual manager has as much as 15-20 goals. It is harder to focus, control and perform on a larger number of indicators. However, many may feel it less risky and more comfortable, due to the diversification. One vice president comments:

The downside is in many ways that the sum of what you can call "must haves" and what you wish to add will make a so called "watering effect" where every measure is 5%, it is a mild effect because "you will not mess up twenty things" in a way. (...) It can be rather comfortable with many goals, because you will always get an okay performance score since you will always succeed on some of the measures.

A challenge for many lower level executives is to balance the demands from above and the expectations from below. As recognized by one vice president, there is a point in the

organizational hierarchy where a manager meets great demands from both below and above, as opposed to higher executive positions where delegation is a greater part of the job assignment:

The risk is that there are too many [measures] and it will result in a dilution. Pressure from the side, from above and below about how many [measures] to include will end with “throwing in the towel” and so you are stuck with 20 goals. So, each one is worth so little that you will get a three in performance score anyway. This is a constant challenge.

On vice president confirms that there might be a problem to fully reflect the importance of a job in the performance measures, especially when many of them are predetermined by their manager or the division:

There are so many different and predetermined criteria that you do not exactly feel your everyday work reflected in more than 20 – 25% [of the measures].

This might result in different interpretation of the importance, and people perceiving different importance from the same set of measures (Bourguignon, 2004). The focus might reflect the manager's individual perception and personality, not the intended purpose of the measures. It can be a significant control problem when individuals interpret the situation and prioritize differently. One human resource manager comments on how the manager's personality to a great extent influences the interpretation and use of the systems:

The quality of your delivery goals are very much dependent on the standards you have as a leader, the values you have as a person and your behaviour.

Another leader confirms this by commenting that many managers choose to focus on delivery when setting performance goals and conducting performance appraisals:

Theoretically I think focusing on both delivery and behaviour is a good idea. But in practise I believe that delivery is weighed much heavier than behaviour. This varies from unit to unit, even though the principle is correct.

Other behavioural displacement problems

One issue frequently described in incentive theory and literature is the problem called the ratchet effect (Lazear and Gibbs, 2008; Gabrielsen et al., 2007). One common way of setting targets in StatoilHydro is using relative numbers compared with previous periods, for instance

a growth of some percentage from last period. This system will motivate to insignificant performance in the first period, in order to get simpler targets the next periods. This issue is especially problematic if measures are highly correlated with incentives. The ratchet effect might have been an issue in StatoilHydro before Beyond Budgeting. However, today's subjective and holistic performance evaluation may solve the problems. Nevertheless, there may still be situations where the ratchet effect is relevant. One manager confirms the goal setting as a relative process building on previous year's results:

If you got a result of, let's say X, last year, it is common to expect an improvement of some percentage of X this year.

Other performance management issues frequently mentioned in management control literature are the issues of manipulation and gamesmanship (Merchant, 1985). One manipulation problem might be different interpretation of the systems, resulting in manipulation in the target setting process. Nonetheless, the holistic and subjective performance assessment will help prevent manipulation and gamesmanship. One human resource manager emphasizes the importance of performance appraisal after the measurement period:

Today we measure on both KPIs and actions, so we measure the entire delivery. And at the end of the year you are to evaluate yourself and ask yourself; "How ambitious were the goals actually? Have I done the right things? Could I have performed better?" These things are much easier to recognize after the period, so today we have much better performance evaluation.

However, when the system is based on the fact that you are supposed to set your own goals there might still be a question whether manipulation can be a problem. In addition, there might be an issue when performance evaluation to a large degree is subjective; it might be subject to bias and manipulation. However, the systems include safety nets like personnel control departments and the guarantee from the manager's manager. So transparencies in the systems may solve some of the potential problems. One vice president explains:

There are situations when a manager is angry with his co-workers and gives them bad scores because of that. He has clearly misinterpreted the system, and hopefully the personnel department will solve the problem.

5.2.3 Conclusions of performance measurement issues

To conclude the performance measurement chapter, it is possible to use the performance measure characteristics of Friestad (2008). She claims that the set of performance measures should satisfy certain requirements; they should be relevant, precise, complete and responsive.

As discussed, performance measures are relevant if they reflect the overall business strategy. Using a Beyond Budgeting approach secures that overall business strategy and value creation are significantly reflected in the performance measurement system. However, when using a Balanced Scorecard approach in combination with behavioural measures, the total number of performance measures is large, and there might be a question whether all of them are equally relevant. For instance, many managers claim that it is difficult to set correct behavioural goals and to make all of them relevant. This is especially an issue when the behavioural goals are linked to predetermined organizational values.

Another issue with relevance is that the performance measurement system needs to support the organizational structure, in order to account for the mutual dependencies. StatoilHydro has a matrix structure with vertical asset departments and horizontal process divisions. However, the system is very much designed for the vertical hierarchical structure only. It is a challenge to make the matrix structure work perfectly when a strong system as the performance measurement system primary works vertically.

The second characteristic is precise. Friestad (2008) highlights that the targets need to measure what they are supposed to measure, and thereby be measured correctly and in the absence of manipulation. As discussed, the probability of manipulating the systems is rather small. However, when a large part of goal setting and performance appraisal is subjectively conducted by the manager, there might be a problem with manipulation or biased opinions. It is clear that a critical success factor for this system to work is the individual manager. The system demands much from every single leader, when it comes to fully understanding the systems, setting the right goals, making the subjective performance evaluation fair and professional and using sound business judgement. This is a fundamental part of decentralization, but still a risk factor for the system to work as intended.

The third characteristic of Friestad (2008) is completeness. She says that the set of performance measures should reflect every important aspect of the work assignment or project, in order to avoid too much focus on single areas or myopia problems. She suggests using the Balance Scorecard as a management system. It should include a comprehensive set of performance measures, but the total number of measures should be kept limited. StatoilHydro uses the Balance Scorecard approach with five different focus areas; this is a solution to the problems with wrong focus. The scorecard balances measures on every aspect. In addition StatoilHydro uses behavioural goals and measures on value compliance. They measure on both key performance indicators and the actions necessary to get there; this is a complete way of addressing the delivery process. However, there is an issue that many managers feel they have too many measures and consequently do not feel committed or motivated by them. This may lead to dysfunctional behaviour, where for instance managers concentrate on only the measures they perceive to be the most important.

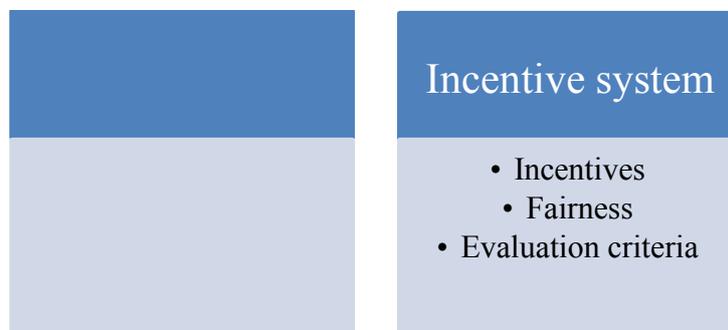
The last characteristic is responsiveness; the performance measure should be controllable by the individual responsible (Merchant et al., 1987). This problem is addressed with the “People@StatoilHydro” process where every individual supposedly takes a greater part in their own goal setting process. However, there are especially two issues necessary to address. First of all, many managers have shared targets as a member of a staff or group, this is a directly violation of the controllability principle. Also, many managers feel that the predetermined measures are so numerous that they only see their main work assignments reflected in a smaller part of the total number of measures.

Second of all, uncertainty is such an essential part of today’s business environment that the performance management system needs to account for it. In StatoilHydro this is solved by using relative and flexible targets, by adjusting the targets during the period and by subjectively evaluating the performance after the measurement period. Relative targets are a suggestion by the Beyond Budgeting Roundtable (2009). Nevertheless, many managers consider it difficult to set and measure against the relative targets, and to change the measures during the period. Some experience that employees feel lack of commitment and motivation towards the goals when they are subject to changes, and also frustration if they feel their performance not reflected in the newly changed measures and evaluation.

In today's rapidly changing environment there is a great demand for dynamics in the management systems. Managers identify the strategic management system "Ambition to action" as a highly dynamic system. Nevertheless, these dynamics are not reflected in the "People@StatoilHydro" process, which is a much more static system. However, some managers identify this issue to be outside the systems, due to the argumentation that human resources and human mindsets never will be as dynamic as the financial resources.

5.3 Incentive system

The last element of performance management is the incentive system connected to performance measurement. This chapter will discuss and analyse the incentive system in StatoilHydro. First different *incentives* will be described, second the subject of *fairness* will be examined, and third the reward *evaluation criteria* of Merchant and Van der Stede (2003) will be applied to the incentive system. Lastly, a short conclusion of the most central challenges with incentive systems will be presented. For an illustration of the structure of this chapter, please find a reminder of the theoretical framework below.



5.3.1 Incentives

Performance based compensation is very common internationally, and many larger multinational corporations use strong performance incentives. Individual financial bonuses have traditionally not been that common in the Norwegian culture. However, in today's businesses it is becoming more widespread (Bragelien, 2003). As expressed by one human resource director:

StatoilHydro is a large company competing in the international arena, and it is obvious that our international competitors like Exxon, Shell and Total have a much greater extent and strength of performance based pay. We are a Norwegian company

based in the Norwegian social democracy, and with performance based pay to a much smaller extent.

The bonus payout can be up to 50% of the base salary, and is normally around 15-20% for an average vice president. This is a rather strong incentive. The bonus payout structure and strength is commented by one vice president as follows:

The bonus payout is maximum 50% for the CEO, 40% for executive directors, 27.5% for first line of managers and 17.5% on the next level. So if you think about it, 17.5% plus a corporate bonus of 5% is 22.5%, and 32.5% for the next level, and that is a strong incentive.

In StatoilHydro the performance evaluation is linked to the incentives system, although this link is much closer and stronger at higher corporate levels. Only around 1000 managers in StatoilHydro ASA take part in the individual performance based bonus scheme. These managers receive up to 50% of their base salary as a performance based bonus. The performance score from the delivery and behaviour matrix acts as a basis for the bonus payout. Even though only a minority of managers receive the individual bonus, every employee takes part in the corporate bonus scheme; which is the same percentage for all employees dependent on overall company success. In addition, some divisions use a business area bonus, up to 5% of base salary depending on business area performance. However, the performance evaluation will have consequences for every employee. Wage increases depend on the performance score, as well as future career developments. Consequently, incentives systems are clearly used when addressing some of the principal agent problems. As confirmed by one senior vice president:

There must be a connection between your contribution to the company success and your risks. From principal agent theory, we know that there are no other ways to give people incentives than to make them bear risks. That is just the way it is, if you have a leadership position. When it comes to bonus for the general worker, it is a token that there is a relationship between what we can give you and the overall company performance. It is a reminder that money is not made without effort. It has a disciplinary effect.

Another type of commonly used incentive is acknowledgment, even though this is not directly connected with the performance measurement system. A vice president explains the

frequently used “close-up” meetings where managers express their interest and enthusiasm with employees’ work, as a way to give acknowledgement and praises:

We use so called “close up” meetings, where the executives meet with employees to discuss their projects. To get acknowledgement and be seen is an important incentive.

Furthermore, Bragelien (2001) argues that incentive systems are most appropriate if the results are easily measured, and may be inappropriate if the job assignments are diverse and complex. This might be the case in StatoilHydro, which is a knowledge incentive organization. However, the majority of interviewed managers are positive to the use of financial performance dependent bonuses. As expressed by one senior vice president:

I think financial bonuses are appropriate because they give incentives and motivation to higher performance. I believe it is the right thing to reward a person who performs significantly better than others.

StatoilHydro does not use team bonuses to a larger extent. Some operates with a smaller fraction of the corporate bonus being business unit dependent. However, these are not linked to any performance contract. Every individual has an individual performance contract, linked to individual performance evaluation and to some degree individual performance dependent incentives. Managers confirm that team bonuses would have been appropriate in many situations, especially in relation to teamwork. One project manager comments:

I see the challenge with team versus individual incentives. Because you may argue that our individual managerial bonus solution does not necessarily build a strong team culture in the organization.

As discussed by Bragelien (2001, 2003) there are both pros and cons with individual performance based incentive systems. He argues that incentives may motivate the employees to work harder. However, if not designed properly, incentive systems may encourage short-sightedness and other behavioural displacement problems, make employees bear unnecessary risks and destroy creativity, interests and cooperation. As discussed in chapter 5.2.2, these problems may also arise at StatoilHydro. Further, Bragelien discusses that individual incentives may discourage teamwork; this might be an issue in a company like StatoilHydro, where processes between individuals and functions play a significant role for company performance.

5.3.2 Fairness

An issue always relevant when analysing incentive systems is the topic of fairness. If employees feel that the management systems or evaluation systems are unfair, it is a critical threat to motivation and satisfaction. People who feel unfairly treated at the workplace, will after a while experience frustration and lack of motivation (Adams, 1965). The interviews have identified situations where managers are insecure about the actual performance appraisal. Many employees may feel that their performance score is unfair and the reasons for it not being clearly communicated.

In a system that uses subjective evaluation to a large degree, there might be difficulties in clearly and fairly communicating and explaining the results. One challenge is evaluating employees on their values and behaviour. One vice president expresses his frustration regarding behavioural measures:

It is weighted a great deal! Actually it is equally important as delivery. It is a difficult discussion. It is harder to set behaviour goals, for instance you should behave more like this and less like that, and in the end of the year you are supposed to score the performance one, two, three, four or five. It is almost like an old-fashioned popularity contest. It concerns the human mind and human behaviour. It is not easily and fairly measured!

In addition, when the performance evaluation to a large extent depends on individual behaviour and values, people may find the results unfair and frustrating. One manager is frustrated with the subjective evaluation process and questions the accuracy of the final performance score:

What is interesting to look at is the reason behind performance evaluation. We measure on delivery and behaviour, but what are the actual inputs to performance evaluation? First, is your own performance appraisal, which you always have to do. Second, is your manager's evaluation of you. These two may conflict. Third, is the ESV questionnaire, even stronger values, where you are evaluated; you evaluate yourself, your manager evaluates you, your colleagues evaluates you, your co-workers, on a scale from one to five. The question is; how much does this actually count?

Another issue regarding subjective performance evaluation is how to use the scale correctly and fairly. It is a fact that managers have used the evaluation scale from one to five differently. There have been several workshops and documents on how to correctly use the scale during the past year. One project manager expresses his frustration regarding the evaluation scale:

One challenge with this system is to make it fair across the organization; use the scale equally and communicate openly and honestly. The scale is one to five, and in general employees are a three. In my department we recruit the best talents in Norway and outside Norway, they may be five or even more, and when they start working for StatoilHydro they all end up as a three. It is difficult to use the scale correctly, and many may find it unfair.

Managers in StatoilHydro have recently started a so called Pre-review meeting where they discuss their scores in a team, in order to make the performance evaluation as equal as possible throughout the organization. One human resource manager suggests that this might be one solution to the challenges with performance scoring and fairness:

This year we introduced a pre-review meeting, where several managers discussed the performance evaluation process before the individual evaluation, to get comments and suggestions. People have different views on how to use the scale, and we get better every year. These pre-review meetings should contribute to increase the quality of the evaluation.

5.3.3 Evaluation criteria

As introduced in the theoretical chapter, Merchant and Van der Stede (2003) identify some criteria for performance-dependent rewards, to secure ideal motivation. First of all, the reward should be *valued* and be large enough to have an *impact*. Second of all, the reward should be *understood*. Third, the reward should be *timely*. Lastly, the reward should be *cost efficient* in order to be beneficial for the company.

Reward should be valued and have impact

The first criterion from Merchant and Van der Stede (ibid) is that the reward should be valued and large enough to have an impact, in order to have the ideal motivational effects. When asked what the motivational factors of work are, managers almost never answer compensation or financial rewards. Challenging and interesting work assignments are ranked highest when

it comes to work motivation. People tend to value their wages a great deal, but seldom the marginal wages. The question of value is a question of strength in the bonus payout, as commented by one vice president:

When it is 20 – 30% it means a lot, so the maximum payout is significant. Let us say you have 27.5% maximum individual bonus, this means that if you do a very good job you might get 18, 19 or 20% bonus. This is clearly significant and will have an impact. When you get smaller amounts for instance five or 10%, it is not as strong and it does not matter that much.

Another issue destroying the motivational effect is when employees take the bonus payout for granted, and the incentive acts as a punishment in the periods where the bonus payout is zero. One manager declares that this may be a problem:

After a while, many will take it [the bonus payout] for granted, as a part of their salary. There are many views on whether or not bonuses are the right way to go.

One way for the performance based reward to have impact is by being visible. If the performance score or the bonus payout is visible to others in the organization, the motivational effect and the value of the reward is enhanced. However, performance evaluation and scores are not visible at StatoilHydro, they are anonymous. Nonetheless, the reward of acknowledgment is visible throughout the organization. The sporadic use of acknowledgment as an incentive is not systematic, although it may be highly motivational. It is a commonly used tool, but not linked to the performance contract or the holistic evaluation system.

Reward should be understandable

In order to be understood, the employees should understand the reasons for both the performance evaluation and the bonus payout. As discussed in chapter 5.3.2, many employees do not understand the reasons for their bonus payout. Many understand and accept the evaluation and the final score, but to many it is unclear how the final bonus payout is calculated. One human resource director explains how the bonus payout is calculated and how it can be difficult to understand the final results:

There are different types of bonus contracts; I can explain the most common one. If you have a maximum bonus payout of 15% or 17.5% of your base salary, you need to have five-five in performance score on delivery and behaviour to get the maximum

percentage. The matrix of one to five includes different percentage figures. If you have a three-three score, which is a good score, the manager can give a bonus from for instance 10 to 13%. Then it is the individual subjective evaluation from the manager that decides the final percentage payout.

Reward should be timely

One criterion is that rewards should be timely. In order to ensure motivational effects the performance based reward must be given soon after the performance that is to be rewarded. In StatoilHydro the bonus is only given once a year, in March. The system may lose some of the intended motivational effects when providing the financial bonus payout more than one year after the actual rewarded performance. However, the directors claim that this it is the most cost efficient way of distributing the compensation, as explained by one human resource manager:

The bonus payout is once a year. It is about efficiency, because it demands a lot from the division handling the transactions and these things.

Reward should be cost efficient

Another issue with financial reward is whether they are cost efficient or not. It is obviously best for the company to provide maximum motivation to a minimum cost. Especially in Norway, with high marginal taxes, the amount given by the company is much greater than what the employee actually receives. When compared to acknowledgement, financial bonuses are very expensive, as commented by one vice president:

Other incentives are recognition and acknowledgement, and of course they are inexpensive. So in that manner, they are much more cost efficient. But we need money to live off of, so clearly they appreciate it, even though many of our leaders earn more than the average in Norway.

5.3.4 Conclusion of incentive system challenges

A clear and strong relationship between performance measurement and incentives is identified at the higher organizational levels; the managers participating in the Annual Variable Pay Scheme. Although only around 1000 managers have the individual bonus, its strength is reasonably intense with payouts of up to 50% of base salary. On the other hand, the relationship between performance measurement and incentives is not as strong for the other

employees, even though a relationship is present. The performance score will have consequences for base salary and future career developments.

Two main issues with the incentive systems are identified. First of all, some consider the performance appraisal and final bonus payout to be unfair. This is mainly due to the subjective performance evaluation and use of the performance scale. As discussed in chapter 5.2.3, a critical success factor for the systems is the individual manager. This performance evaluation and incentive system demands a great deal from the individual leader. It is a requirement that the manager fully understands the system and conducts a professional and fair performance appraisal of every employee. In addition, many divisions have recently introduced so called “Pre-review” meetings, where managers get together to discuss the performance evaluation and how to use the scale and evaluation criteria. Second of all, StatoilHydro does not use team bonuses to a large extent. When the incentives are strong and the performance evaluation and incentives are individual, the incentive system may jeopardize collaboration. It is a suggestion that StatoilHydro uses team bonuses, especially in departments and cross functional projects where cooperation and teamwork are particularly important.

When using the reward evaluation criteria there are particularly two issues that may destroy some of the intended motivational effects. Firstly, the incentives used in StatoilHydro do not have a huge impact on the employees at the lower levels of the organization. As identified by several managers, a small percentage bonus payout does not have a sufficiently large impact. Furthermore, the connection between performance score and changes in base salary does not have a strong impact since the changes are relatively small. Secondly, the incentive system at StatoilHydro is not sufficiently timely. The bonus payout is once a year, providing the reward up to more than a year after the rewarded performance. This is not sufficiently motivational. In addition, one may argue that financial bonuses are not satisfactorily cost efficient. More cost efficient rewards, like recognition and acknowledgment, should be used in a more systematic way in relation to the performance measurement system.

5.4 Conclusion

This analysis identifies a strong relationship between performance measurement and incentives at higher organizational levels. However, this relationship is not as strong at lower

hierarchical levels, nevertheless, the relationship is still present. To conclude the analyses and address the key implications and challenges identified, the following discussion will be divided into two parts. First of all, the leadership role as a critical success factor for the relationship between performance measurement and incentives will be discussed. Second of all, the importance of relevance and dynamics in the performance management system will be examined.

5.4.1 The leadership role

As identified in the previous analysis, every individual manager at StatoilHydro is a critical success factor for the management control system to work as intended. When it comes to performance management, the leader has a responsibility to secure the relationship between performance measurement and incentives. Addressing this challenge, five subjects will be discussed as a summary of the analysis.

First, this system requires that every manager fully understands the entire management control system and identifies oneself with the StatoilHydro values and desired behaviours. Second, critical for the performance measurement is the goal setting process. The manager must ensure ambitious but achievable goals for oneself and for the managers below. One challenge is to set the right goals and make them SMART. The manager must also account for the controllability principle and ensure commitment to the performance measures. Another challenge is the relative and flexible measures suggested in the Beyond Budgeting approach. Third, the manager must prevent behavioural displacement problems. In order to address this issue, the manager needs to balance short term and long term measures, and delivery and behavioural goals, and make sure that the total number of measures is limited. Fourth, the performance appraisal requires a great deal. The performance evaluation needs to be unbiased, professional and fair. The manager needs to make decisions based on all the inputs, sound business judgement and values. In addition, a correct use of the scale is important, dialogue and comparison with other managers might help in this process. Finally, in order to secure a strong relationship between performance measurement and incentives, the leaders at StatoilHydro need to make sure that performance has a consequence. Frequent use of acknowledgement, financial bonuses, if possible, and career development plans, in connection with performance may have the right impact and motivational effects.

It is obvious that the leadership role in StatoilHydro is a critical success factor for the management control system and for the relationship between performance measurement and incentives. Autonomy and trust is a basic assumption in the Beyond Budgeting philosophy. Decentralization and trust is a widespread approach to address the dynamic and uncertain business environment; to rapidly adjust to the changing marketplace and to stay competitive. However, in a multinational company like StatoilHydro the risks of making every manager bear this much responsibility is a constant challenge. In StatoilHydro some of these issues are addressed using careful selection processes, internal leadership training and internal recruitment to leadership positions.

5.4.2 Issues of relevance and dynamics

This section will examine two additional important issues with the performance management system at StatoilHydro, identified in the analysis. First, the importance of relevance will be concluded. Second, the challenges to cope with uncertainty will be discussed.

The principle of designing and implementing relevant systems is a question about supporting the overall business objectives and purposes. When evaluating a performance management system it is important to look for relevance in both system design and system usage. When studying the design of the system two concerns may be remarked. Number one, the performance measurement system uses the Balanced Scorecard approach to delivery goal setting. In addition, the set of measures includes behavioural goals and value objectives. This is to ensure that every important aspect of a work assignment or project is accounted for, with a strong focus on behaviour, actions and values. The set of measures is complete and relevant, although a challenge may be to set a limited total number of measures, in order to secure commitment, enthusiasm and limit the possibility of personal perception and prioritizing of the importance of the measures. Number two, StatoilHydro is organized as a matrix structure, with vertical assets and horizontal supporting processes. The performance measurement system is very much designed for hierarchical vertical purposes. It may therefore be a challenge to secure the horizontal interdependent processes. When commenting on the use of the system, one challenge is to make the actual performance measures relevant. When using many performance indicators and actions it is a challenge to make every single one of them relevant to both the individual and the overall business strategy. Behavioural measures are

especially challenging, and several managers comment that they feel it is difficult to set correct and relevant behavioural goals.

In today's uncertain and unpredictable business environment, it is necessary to have a dynamic management control system for rapid changes to the market conditions. This is especially important in a company like StatoilHydro which is heavily dependent on the extremely volatile oil price. In addition, StatoilHydro needs to cope with changing markets and financial conditions, and shifting demands from stakeholders. The strategic management system "Ambition to action" which has been implemented in the entire organization is a relatively dynamic management process. The system is especially dynamic in resource allocation, but also in planning and forecasting and target setting. The system is designed to be easily adjusted to changes in market conditions. However, the performance management system "People@StatoilHydro" may not be as dynamic. First of all, it is a challenge to make relevant performance targets that are dynamic and still ensure high commitment and motivation. Frequent changes in performance targets may result in frustration, indifference and excessive use of management time. As commented by one senior vice president; his focus and attention changes faster than what the system can comprehend. Thus, it is difficult to set dynamic performance goals. Second of all, there is the question of whether human resources can ever be as dynamic as intended by the systems. Human resources can never be as dynamic as financial resources. Hence, it is a challenge to reflect the dynamics from the strategic management system in the performance measurement system.

Chapter 6: Conclusions

The aim of this chapter is to conclude the thesis, and will include a summary of the findings and suggestions to further research. The problem statement of the report has been:

What is the relationship between performance measurement and incentives?

The methodology used in addressing this problem statement has included qualitative in-depth interviews with managers in the multinational energy company StatoilHydro, with a semi-structured interview guide building on a theoretical framework. First of all, the developments of management control systems, performance measurement and incentives have been examined both in theory and literature, and in StatoilHydro. Second of all, the present performance measurement and incentive systems at StatoilHydro have been analysed, and some challenges and implications for management control practices have been identified. This chapter summarizes the results and suggests further research.

6.1 Main findings

Based on the theoretical framework and the research conducted, this study has identified three important challenges with performance measurement and incentives. Firstly, a consequence of the Beyond Budgeting approach is changes in the leadership role, especially in relation to performance measurement and incentives. Secondly, system relevance is a challenge in relation to reflecting overall business strategy, purpose and organizational structure. Finally, the issues of dynamics are particularly important in today's business environment, and the systems need to comprehend these.

First of all, the study identifies that the leadership role changes with the Beyond Budgeting approach, and especially with respect to the new performance measurement and incentive systems. Leaders at every level are key success factors for these systems, and particularly during the implementations. The managers are supposed to take part in their own goal setting and performance appraisal process, in addition to every employee's at the level below them. This requires a solid target setting process with emphasis on specific, measurable, ambitious, achievable, relevant and timely goals. In addition, the managers need to conduct professional and fair feedback during the period and evaluation and performance scoring after the period. This implies that the leader needs a deeper understanding of the systems and the values, and

identifies oneself with these. Even though increased responsibility and accountability for the individual manager are essential elements of every decentralization process, one must not forget the risks this implies. Responsibilities for performance and incentives are delegated far down in the organization, in addition to processes like resource allocation, investment opportunities, health, safety and environment; this might result in control problems.

When studying system relevance three issues are important to address. First of all, the relevance of a strong behavioural focus in performance measurement and incentives may be debated. The importance of a strong focus on values and behaviour is non-negotiable. However, many managers find it difficult to relate this directly to performance measurement and incentive systems. Many feel it extremely hard to set relevant behavioural goals, to measure these, give constructive feedback and evaluate and score the performance. Second of all, when using both the Balanced Scorecard approach with targets on five different perspectives, behavioural targets and measures on values, the total number of measures addressed to each individual manager is an issue. When using more than 20 different performance goals, people tend to lose their focus and motivation towards goal achievement. In addition, managers might perceive the importance of the goals differently. Thus, it may differ what a manager decides to focus on. Lastly, the overall business strategy and purpose must be reflected in performance measurement and incentives. StatoilHydro is organized in a matrix structure with vertical business assets and horizontal processes. However, the performance measurement and incentive systems work mostly hierarchically in the vertical functional line. This is a challenge for the interdependent processes and the overall purpose of the business.

Finally, the issues of dynamics are argued to be more important today than ever. It is a challenge to make the systems dynamic, especially in relation to the human resource processes. The strategic management system in StatoilHydro is regarded to be a dynamic system. However, the dynamics are not fully reflected in the performance measurement and incentive systems. Goals are primary set for one year at a time, and seldom changed during the year. A success factor for securing dynamics in the entire management control system is dynamics in the performance management system. However, there is a challenge to make the human resources as dynamic as the financial resources.

6.2 Suggestions to further research

This study represents general research on the topics of performance measurement and incentives. Thus, in-depth focused studies are suggested as further research. The management control approach of Beyond Budgeting is still a less studied field with many possible research angles. Especially interesting is the connection between management control systems and performance management systems. One interesting research topic would be to study this connection and the relationship between performance measurement and incentives at lower organizational levels. A limitation in this thesis might be that the research is conducted at higher managerial levels only. The same research at lower levels might have revealed other issues and challenges. Another approach would be to study the implementation of Beyond Budgeting and performance management systems in StatoilHydro the next couple of years, to identify whether the discovered challenges are in fact weaknesses in the system design or simply due to the very recent implementation.

Identified by this study, particularly three approaches will be relevant for further studies. First of all, it is relevant to examine the changes in the leadership role. One question is whether the Beyond Budgeting approach demands any specific knowledge and certain qualifications from the leader, and if this implies significant implications for management accounting and control. Furthermore, one may examine whether decentralization is in fact the most successful strategy to cope with uncertainty, as argued by Beyond Budgeting enthusiasts. It is possible that decentralization is only fruitful to a given point, and further research might be able to identify this point.

Second of all, the identified challenges with relevance may be examined further. An important purpose of management control practices is to secure a high level of dependency and congruence between the different systems, and prevent conflicts between them. Thus, an interesting research topic is the connection and congruence between performance management and organizational structure. This may be expanded to include other organizational processes like resource allocation systems, planning and control, information technology infrastructure and human resource management systems.

At last, when it comes to the challenges of dynamics, there are many interesting angles of further research. One research topic may be how to make the design of performance

management systems more dynamic in relation to the overall management control system. Further, it is relevant to study the maximum level of dynamics desired versus the actual level of dynamics possible. Research might identify how to profitably make human resources more dynamic, and if this in fact is possible.

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Appendix 1

Intervjuguide: Del 1 - HR ledere

Husk:

- Spør hvorfor!
- Hvis de bruker et ord/uttrykk mye, spør hva de mener med det.
- Spør etter eksempler.

GENERELT:

1. Kort presentasjon av forskningen generelt og intervjuet spesielt.
2. Hvilken rolle har du i organisasjonen? Hva betyr Beyond Budgeting for deg?

FOKUSERT:

Kan du forklare hvordan **prestasjonsmåling** var tidligere? (Før Beyond Budgeting)

- a. Hvem ble målt før?
- b. **Hva** ble de målt på?
 - i. Ett måleparameter? Mange? Hvilke?
 - ii. Finansielle/ikke finansielle?
 - iii. Hva var de knyttet opp mot? Budsjett? BSC? Budsjettsavvik?
 - iv. Riktige måltall? Relevante? Presise? Uttømmende/komplette? Responderende?
- c. **Hva var utfordringene med dette systemet?**
- d. **Hva var fordelene med dette systemet?**
- e. Strakk dette systemet til? Spesielle reaksjoner eller problemer?
- f. Hvordan var målingen knyttet til **belønning**? Hvordan ble de ansatte belønnet før? Monetært? Ikke-monetært? Fastlønn? Bonus? Var det prestasjonsbasert? Forfremmelse?
- g. **Hva var utfordringene med dette belønningssystemet?**

Kan du fortelle hvordan **prestasjonsmålingssystemet** er i dag?

- h. Hvem blir målt?
- i. **Hva** blir de målt på?
 - i. Ett måleparameter? Mange? Hvilke?
 - ii. Finansielle/ikke finansielle?
 - iii. Hva er de knyttet opp mot? BSC? KPIer? 5 perspektiver?
 - iv. Delivery og behavior?
 - v. Riktige måltall? Relevante? Presise? Uttømmende/komplette? Responderende?

- j. Har problemene fra tidligere blitt løst?**
- k. Hva er fordelene med dette systemet?**
- l. Hva er utfordringene med dette systemet?**
 - i. Reflekteres bedriftens /avd overordnede strategi, mål og oppgaver?
 - ii. Måles de riktige tingene?
 - iii. Måles alt som er viktig, eller kun deler av det?
 - iv. Har du full påvirkning og kontroll over måletallene?
 - v. Blir de forskjellige delene vektet riktig?
 - vi. Er systemet enklere å forstå?
 - vii. Er det for mange eller for få måltall?
 - viii. Er det mulig å manipulere resultatene?
 - ix. Strategisk fokusering? Du får det du måler: Kun fokus på målene?
 - x. Gir systemene andre uønskede incentivvirkninger?
- m. Hva er belønningene i dag?**
 - i. Hvor sterke er incentivene?
 - ii. Manipulasjon av resultatet?
 - iii. Verdi for den ansatte?
 - iv. Forstår de ansatte systemene?
 - v. Er belønningen tidsnok?
 - vi. Er det kostnadseffektivt for avdelingen/bedriften?
- n. Mener du utviklingen har vært til det bedre?**
- o. Hva er forholdet prestasjonsmåling/belønning?**
 - i. Ser de ansatte at deres prestasjoner har en konsekvens?
 - ii. Opplever du at de ansatte verdsetter denne konsekvensen?
 - iii. Hva tror du er den viktigste grunnen til at ansatte presterer? Ikke presterer?

Appendix 2

Intervjuguide: Del 2 – Alle ledere

Husk:

- Spør hvorfor!
- Hvis de bruker et ord/uttrykk mye, spør hva de mener med det.
- Spør etter eksempler.

GENERELT:

1. Kort presentasjon av forskningen generelt og intervjuet spesielt.
2. Hvilken rolle har du i organisasjonen? Hva betyr Beyond Budgeting for deg?

FOKUSERT:

Kan du fortelle hvordan **prestasjonsmålingssystemet** er i dag?

- a. **Hva** blir dere målt på?
 - iv. Ett måleparameter? Mange? Hvilke?
 - v. Finansielle/ikke finansielle?
 - vi. Hva er de knyttet opp mot? BSC? KPIer? 5 perspektiver?
 - vii. Delivery og behavior?
 - viii. Riktige måltall? Relevante? Presise? Uttømmende/komplette? Responderende?
- b. Hvordan har utviklingen vært fra tidligere systemer? Har noen av eventuelle utfordringer fra tidligere blitt løst?
- c. **Hva er fordelene med dagens system?**
- d. **Hva er utfordringene med dette systemet?**
 - i. Reflekteres bedriftens /avd overordnede strategi, mål og oppgaver?
 - ii. Måles de riktige tingene?
 - iii. Måles alt som er viktig, eller kun deler av det?
 - iv. Har du full påvirkning og kontroll over måletallene?
 - v. Blir de forskjellige delene vektet riktig?
 - vi. Er måltallene spesifikke og målbare? Hva er utfordringene?
 - vii. Er det vanskelig å sette strategisk fokuserte mål? Langsiktige mål?
 - viii. Er systemet enklere å forstå?
 - ix. Er det for mange eller for få måltall?
 - x. Er det mulig å manipulere resultatene?
 - xi. Strategisk fokusering? Du får det du måler: Kun fokus på målene?
 - xii. Gir systemene andre uhensiktsmessige incentivvirkninger?

- e. Hva er **belønningene i dag**?
 - i. Hvor sterke er incentivene?
 - ii. Manipulasjon av resultatet?
 - iii. Verdi for den ansatte?
 - iv. Forstår de ansatte systemene?
 - v. Er belønningen tidsnok?
 - vi. Er det kostnadseffektivt for avdelingen/bedriften?

- f. **Mener du utviklingen har vært til det bedre?**

- g. Hva er forholdet prestasjonsmåling/belønning?
 - i. Ser de ansatte at deres prestasjoner har en konsekvens?
 - ii. Opplever du at de ansatte verdsetter denne konsekvensen?
 - iii. Hva tror du er den viktigste grunnen til at ansatte presterer? Ikke presterer?

TIL SLUTT:

1. Hvem er vinnere/tapere i det nye systemet?
2. Hvem ønsker det nye systemet? HR, kontrollere, mellomledere, ledelse, hvem?
3. Er det riktig med finansiell belønning?
4. Blir det for mye måling og kontroll?
5. Er det bedre nå enn før?
6. Hva skal til for å få det nye systemet til å fungere? Er dette store barrierer?
7. Mener du det er et riktig system for hele organisasjonen?