Wanstead Engineering

Case 9

The annual bonus for senior managers at Wanstead Engineering was first agreed in 1998. Since then the company has seen no need to make any changes to the way in which the bonus is calculated. Both shareholders and managers agree the bonus is important, as it is a major factor in motivating and rewarding managers to maximize the agreed corporate objectives. The bonus scheme has also helped the company to retain senior managers. Shareholders want to see a steady improvement in the share price for a given level of risk and the directors are responsible for designing the remuneration systems.

Details of bonus calculation

The original forecast presented by managers was prepared on the assumption that no funds were available for investment in new products. Investments that have already been approved are considered essential to maintain current production capacity.

Original forecast – no funds available for investment in new products

Year	2001	2002	2003
*Profit	£6 million	£5 million	£4 million
Capital employed (at beginning of year)	£77 million	£79 million	£81 million

*Profit is calculated before tax and interest

The bonus is calculated by multiplying the ROI percentage by £1,000 if the capital employed is below £80 million and by £1,100 if the capital employed is greater than £80 million.
The group ignores tax and depreciation when calculating bonuses and the capital employed is the opening balance at the start of each year and excludes cash balances which are held in a group account

Example: Capital employed = £50,000,000
ROI = 7.143%
Bonus = 7.143 X £1,000 = £7,143

Investment in new products

After receiving the forecast above senior managers were asked to identify three investments in new products. The company has been asked to only consider projects with cash inflows in 2002 and 2003. Although the senior managers were asked to identify 3 projects only 1 would be accepted.

Cost of capital is 10%

Project 1			
Year	2001	2002	2003
Cash flow	-£5 million	£4.5 million	£1.5 million
Net present value	£330,579		

Project 2			
Year	2001	2002	2003
Cash flow	-£2 million	£0.1 million	£3 million
Net present value	£570,248		

Project 3			
Year	2001	2002	2003
Cash flow	-£0.5 million	Nil	£1 million
Net present value	£326,446		

Questions

Question 1

Discuss why the bonus scheme could result in poor decisions and cause conflict between shareholders and senior managers.

Question 2

What changes would you like to see to the way in which bonus is calculated? Discuss why strategy is important when identifying financial objectives for a business unit.