INCENTIVE COMPENSATION IN FRITZ HANSEN: THE SHORTFALL OF INCENTIVES THEORY AND THE INSIGHTS FROM CONTINGENCY THEORY

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Abstract

This paper studies incentive compensation at Fritz Hansen, a Danish manufacturer of exclusive design furniture. A vast amount of literature exists within incentives theory. However, regardless of the establishedness of incentives theory it is not able to fully explain the case at Fritz Hansen. Several short-comings of incentives theory are found: managers whose compensation is not tied to BSC measures behave in accordance with these measures; no bonus bank is included in the incentives system to accompany EVA measures on which managers are rewarded but there seem to be no resulting focus on short-term results; managers self-select the bonus measures but they select measures that they cannot directly influence. Regardless of these breaches, the situation at Fritz Hansen seems to be in equilibrium with managers behaving in the interest of the owners and the owner representatives being satisfied with the incentives system. In order to better understand how and why the design of incentive compensation at Fritz Hansen seems to function, contingency theory is drawn upon. While contingency theory provides a usable framework for the study important variables not previously mentioned in contingency theory is missing before the case of Fritz Hansen can be explained. Using the case study method the variables change urgency, the presence of an ultimate lagging goal, the legitimising effect, the system of measurement, non-financial measurement and lastly the controllability principle are extracted from the case. Together, these can explain why EVA is still included as a compensation base and why managers are motivated by BSC measures although they are not part of the compensation base.

Keywords: Balanced scorecard, case study, compensation, contingency theory, economic value added

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Introduction

Incentives and compensation systems have, in light of shorter employment periods and increased pressure from shareholders, become increasingly important mechanisms for employee measurement and rewards (Ittner and Larcker, 1998; Friis and Vámosi, 2004). These systems provide a vehicle for employers to exert influence and align employee decision making according to owners' wishes. Stock options and profit sharing are common compensation practices and increasingly, many companies express a keen interest and focus on fully integrated control and compensation models like economic value added (EVA) and the balanced scorecard (BSC). Hence, literature on and theory within compensation and reward systems is vast (see e.g. Bonner and Sprinkle, 2002 for a review) and research is driven by the wide variety of systems that exist within both private and public sectors.

Fritz Hansen A/S, a Danish furniture manufacturer, provides an interesting research case, as compensation practices at this company are seemingly contradictory to established compensation theory. To reiterate, Fritz Hansen seems immune to problems normally associated with their particular type of compensation plan and therefore this article arises from a curiosity standpoint - from a case study that challenges existing theory.

The bonus scheme at Fritz Hansen is based on EVA, though without the bonus bank system, which EVA developers (Stewart, 1991) recommend for the purpose of motivating long term decision making. BSC is used as a strategy tool and to supplement EVA in compensation in some instances, where employees choose this. At a first glance, the bonus system in Fritz Hansen gives therefore little motivation for long term decision making actions and leaves ample opportunity for employees to apply discretion in their bonus plan composition. It is therefore surprising that employees actually do not behave in conflict with the interest of stockholders and this paradox is the basis for the research project reported in this paper.

Incentives theory's main paradigm is based on the presumption that 'what you measure is what you get' – that is, performance measurement systems are vital tools for directing employee attention and thereby behaviour (Milgrom and Roberts, 1992; Jensen, 2001). A great deal of present literature on incentives and compensation is influenced by agency theory, which defines the firm as a construct of principal and agent relationships (Jensen, 1983). Agency relationships prevail in Fritz Hansen, but interestingly agency theory's underlying assumptions are not upheld and therefore there are gaps in relation to what agency theory can explain in this particular case. Since compensation theory builds on agency theory assumptions, then the case of Fritz Hansen challenges the rule sets within both realms.

Agency theory outlines a set of assumptions about the relationships between agents, employees, and principals, employers, within firms (Jensen, 1983). Agency theory addresses the decentralization of decision making which inevitably occurs in organizations in an effort to match decision making and knowledge (Jensen, 1983). The basis for decentralization is the information asymmetry that exists between principal and agents (Jensen and Meckling, 1992). According to Baiman and Evans (1982) this information asymmetry is often localized within the agent and it follows that the problem with information asymmetry lies within another agency theory assumption, that agents are opportunistic and value maximizing - a consideration stemming from the idea of 'the profit maximizing individual' (Parkin and King, 1995). Goal incongruence implies that agents' decision making does not take the best interests of the firm at heart when this comes into conflict with the agents own profit maximization (Williamson, 1986). Goal incongruence necessitates systems to bring these converging interests into agreement, and these can take the form of compensation plans (Prendergast and Topel, 1993). An incentive system should thereby control self-interested behaviour and motivate the pursuit of organizational goals.

In Fritz Hansen though, agents do not act in self interest and this is in fact not a result of well constructed compensation plans, but rather seems to be a natural state of being. For example, according to compensation theory, utilizing EVA for compensation purposes without the related bonus bank system will lead to horizon problems because of the absence of long term incentives that no bonus bank entails. However, at Fritz Hansen horizon problems are not prevalent and therefore the assumption of opportunistic utility maximization and goal incongruence in the absence of compensation systems to resolve these issues is not upheld.

Merchant (1989, p. 67) state that agents will prioritize in line with compensation, meaning, that if they are rewarded in short term measures, then they will make short term decisions and vice versa. In relation to BSC Kaplan and Norton (1998, p. 100) argue the importance of tying BSC goals to compensation, as this will align decision making with long term strategies. However this is not the case in Fritz Hansen, where agents seem motivated by BSC targets that are not tied to compensation. In fact the BSC system seems highly capable of drawing attention although it is not tied to compensation, which is illustrated in agents' not acting short sighted and knowledge of corporate strategy.

The case study clearly houses a number of contradictions in relation to agency and compensation theories and this poses first a number of limitations within agency theory, but also compensation theory. More interesting in relation to these contradictions is to attempt to find an alternative explanation and for this purpose we wish to utilize contingency theory.

Contingency theory seems promising because Fritz Hansen's compensation and especially the movement away from the bonus bank system can be seen as a result of external contingency factors. In addition, the theory builds on other assumptions than does principal/agent and compensation theories and can therefore contribute to explanations of the circumstances in Fritz Hansen, which this theory lacks.

The paper is organized as follows. In section 0 we will introduce contingency theory by presenting a literature review of studies within contingency theory and compensation theory, keeping in mind the circumstances which prevail in Fritz Hansen. In section 0 the research method will be explained and thereby the outline of the paper's approach to the research questions. Next, in section 0, we will provide an introduction to Fritz Hansen and the company's compensation system in particular. An analysis of the compensation system of Fritz Hansen will be carried out in section 0 and, finally, section 0 will contain a conclusion, limitations and avenues for further research.

Literature review

A discussion of grand theories

Agency theory rests as any other grand theory on a number of assumptions. These assumptions at the same time strengthen and weaken the theory. Without building on assumptions it is hard to develop any kind of theory. On the other hand, assumptions delimit the applicability of theory.

Under agency theory it is assumed that agents are utility-maximising individuals. Agents are rational and posses unlimited computational abilities (Baiman, 1990). Since agents have other motives than principals and since agents are assumed to be risk averse while principals are risk neutral then agents do not necessarily, on their own, behave in the interest of principals (Zimmerman, 2003, p. 170). In order to correct this incongruence of interests a compensation system can be introduced. As long as the compensation system is designed after a certain set of

recommendations the compensation system is assumed to alter the behaviour of individuals. These recommendations regard, among other things, the size of the compensation compared to the fixed pay and the compensation base being aligned with the overall company strategy (Jensen and Meckling, 1992, p. 262). Furthermore, agents must be able to control events that have an effect on the compensation base (Solomons, 1983). Agents are expected to behave so that they maximise their outcome from the compensation system. Following this, agents are not expected to pay attention to measures that are not part of the compensation base. What you measure is what you get (Milgrom and Roberts, 1992, p. 206).

These assumptions of agency theory do not seem to be upheld within Fritz Hansen. It is characteristic of the compensation system at Fritz Hansen and the behaviour of the employees that employees do not give particularly high priority to measures that are part of the compensation base compared to those measures, which they are not compensated on. Therefore, the assumption that a compensation system will alter behaviour of agents does not seem relevant at Fritz Hansen. There seems to be variables that moderate the effect of a compensation system. Contingency theory rests on a different set of assumptions than agency theory. Although, both grand theories are within the functionalist paradigm (Hopper and Powell, 1985; Ryan et al., 2002, p. 75) a very important difference exists. Contingency theory assumes that no single compensation system can fit all organisations (Weill and Olson, 1989; Riceman et al., 2002). The compensation system must be aligned with a number of contingency variables. Thus, while agency theory expects that a compensation system will have an effect in most circumstances; contingency theory only expects a compensation system to be functional under a given set of circumstances. This assumption that a compensation system is only expected to be effective in certain settings seems to be promising when trying to explain why the compensation system at Fritz Hansen does not seem to have the expected effects.

Task uncertainty and compensation

Within the contingency literature on performance management and compensation in particular variables of task uncertainty are relevant to study. Hirst (1981) argues that in situations with low understanding of the relationship between input and output, output measures are inappropriate. Rather, non-financial measures on the process variables seem to be more appropriate (such as BSC). In continuation hereof Hirst (1983) finds that fit exists between low task uncertainty and reliance on accounting performance measures. From an incentives theory perspective this is in line with the argument that incentives are best based on measures that employees can control (the controllability principle, Larmanda and Ponssard, 2003). Following this, in a situation of high task complexity then a compensation system based on financial metrics such as EVA is not appropriate since the employee cannot see the link between carrying out the tasks (effort) and its (expected) impact on the financial metric (no knowledge about the input-output relationship). Rather, it is appropriate to us a financial metric when task complexity is not low (Hirst, 1981).

Business unit strategy and compensation

The relationship between business unit strategy and the incentives system has also been studied from a contingency perspective. Several classifications of strategies exist. Building on the typology of build vs. harvest (Fisher and Govindarajan, 1993), Govindarajan and Gupta (1985) find that for companies pursuing a build strategy it is better to rely on long-run criteria and subjective approaches for evaluation. On the other hand, if the company pursues a strategy of harvest then it is counterproductive to base evaluations on such criteria. Especially the leading indicators of the BSC can be considered long-run criteria. Some would also argue that EVA is a long-run criterion since for example investments in research and development are capitalized and amortized rather than taken as a cost in the year the investment is made. Although such corrections are done to a financial statement we would argue that BSC still is a more long-run criterion. Neither EVA nor BSC can be considered as examples of subjective evaluation. Balkin and Gomez-Mejia (1990) investigate the relationship between strategies of growth vs. maintenance and pay level compared to the market, ratio of incentives to salary and pay policies such as the administrative framework and the criteria. The authors identify two configurations. The first configuration is one with a mechanistic pattern (e.g. emphasis on salary and bureaucratic pay policies). The second configuration has an organic pattern in that contains flexible pay policies and reliance on incentives. Companies pursuing a growth strategy tend to choose an organic pattern with regard to compensation. Now the question is whether EVA and BSC can be coupled with each of the two patterns. Does EVA better belong to a mechanistic pattern and BSC to an organic pattern? One could argue so since an incentives system based on EVA is relatively mechanistic in that number of measures or the formula are not going to change. On the other hand BSC can be considered a more organic system with several measures that can even change over time. Building on this mapping it could be argued that BSC is the more appropriate evaluation criteria for growth companies.

The strategy typology of prospectors and defenders (Miles and Snow, 1978) is used by Boyd and Salamin (2001). The authors investigate the relationship between business unit strategy and the use of incentives. They find that prospectors to a larger degree than defenders emphasize the use of

incentives. Unfortunately, they do not investigate how prospectors design their incentives system.

Environmental uncertainty and compensation

Govindarajan (1984) investigates the relationship between perceived environmental uncertainty (PEU) and reliance on subjective vs. formula-based performance measures. The find that high PEU is related to reliance on subjective performance measures whereas low PEU is correlated with reliance on formula-based performance measures. As stated above, using EVA or BSC cannot be considered using subjective criteria. What is characteristic of incentives systems based on EVA or BSC is that a formula typically is defined so that the employee is not in doubt about how large the bonus will be given a certain level of performance. But a formula might not necessarily be built on top of EVA or BSC metrics. The metrics can be used as a based for a subjective evaluation. BSC contains a number of metrics that the manager deciding on the level of bonus can use as input to a subjective evaluation process. EVA is less useful in such a situation since it consists of only one measure. Thus, companies with high PEU might be better off basing the subjective evaluation on a BSC rather than on an EVA metric.

Research questions

Fritz Hansen was briefly introduced in the introduction and will be further described in a later section. What is characteristic of Fritz Hansen is that the company is pursuing a growth strategy and that it operates in a relatively uncertain environment. The uncertainty in the environment stems from the fact that customers react rather promptly on up- and downturns in the economy since the furniture that the company produces is very expensive. Expensive furniture is among the first things that one can do without in meagre times. The employees on a bonus system in Fritz Hansen are managers performing tasks whose input and output relationship is not possible to map.

With those company and task characteristics current contingency theory would predict or advice that Fritz Hansen bases it bonus system on balanced scorecard measures rather than an EVA measure. But that is not what we observe in Fritz Hansen. This leads to the following research question:

> RQ1: Why is it (what contingency variables) that Fritz Hansen bases its bonus system on EVA when the company according to current contingency theory should base the bonus system on BSC measures?

When we observe a company practice that does not follow the recommendations of theory we would expect that the company experiences negative outcomes. Fortunately (to Fritz Hansen), that is not what Fritz Hansen experiences. Rather, employees seem to be motivated by BSC measures even though they are rewarded on the basis of the EVA measure. This leads to the second research question:

> RQ2: Why are employees motivated by BSC measures while rewarded on EVA?

These research questions will we try to answer taking departure in the case study of Fritz Hansen. But before turning to Fritz Hansen the next section will elaborate on the research method employed.

Research method

When the research questions involve identifying new variables, and when they deal with the whys and hows of the researched object, the case study method is appropriate (Yin, 1994, p. 6). When interviewing, which is an often implemented technique when doing case study research, the opportunity to pursue interesting leads is present. This is, for example, not the case with the survey method, where the survey instrument is developed prior to gathering data. The possibility of extracting data about variables not thought of in advance is a requirement when answering the research questions. Finally, most research within contingency theory and compensation has applied the survey method and, thus, this research applying the case study method adds triangulation to the field (Birnberg et al., 1990).

Contact to Fritz Hansen was taken in February 2005. The first contact was taken with another research project in mind. However at this first meeting, it turned out that Fritz Hansen had interesting experiences with regard to their compensation system and the initial research topic was skipped for the benefit of the present research project.

A total of nine interviews were conducted in the period ranging from February 2005 to August 2005. Interview persons were selected so that managers as well as employees and employees with different compensation schemes were interviewed. The interviews were semi-structured in that they were guided by an interview guide that allowed for the pursuit of interesting leads. The respondents were promised confidentiality and whether the interviews could be tape recorded. No interviewees asked the interviewer to turn off the tape recorder. All but two interviews were transcribed verbatim.

The company was very accommodating and the researcher conducting the interviews was offered a workstation at the site. Spending time at the site implies that direct observations could be added to the list of sources of evidence. In addition hereto, spending time at the site and gaining confidence with the employees are means for reducing the threat to validity that arises when the researcher enters the field (McKinnon, 1988; Birnberg et al., 1990). All requests for interviews and material were accepted and the data material constituting the basis of this research project consists of interviews, documents and direct observation (Yin, 1994, p. 80).

Introduction to Fritz Hansen

The story

Fritz Hansen A/S is a Danish furniture producer of high end architecturally designed products. Fritz Hansen employs 205 people of which about 100 are included in a compensation scheme based on EVA. The development of current compensation practices at Fritz Hansen can be traced back to 1999, when Fritz Hansen was one of several companies in a furniture producing corporation – but one of the only entities making a profit. At this time Fritz Hansen defined itself as a traditional furniture producer with focus on optimizing production and production processes. Early in 1999 the corporation introduced EVA as a coordination and control mechanism for the whole firm. This was done through a comprehensive presentation to the model and with the help consultants from Stern Stewart & Co.

Around the time of this implementation, in mid-late 1999, it was decided to let Fritz Hansen operate as its own independent company – thereby becoming its own organisational entity. However, as a result of a lack of investments in production equipment in previous years, management at Fritz Hansen faced challenges living up to demand. The position that Fritz Hansen found itself in, in 1999 was in large part the result of a redundant production fixated strategy, which was no longer viable in the current marketplace. To develop Fritz Hansen and meet these challenges, a substantial investment program of 300 million DKK (approximately equivalent to 40 million EUR) was instigated and a strategic overhaul was initiated. The EVA system, which had recently been implemented in the entire corporation, was implemented as the main method of coordination in the newly independent company Fritz Hansen A/S. EVA was to be used as an overall control mechanism, to measure performance and growth, but also as a tool in investment decisions and in reward systems. A compensation system based on EVA was therefore implemented, with the goal of creating a fully integrated coordination system, which would communicate to all employees at Fritz Hansen a shared ideal of value maximization.

It is important in terms of the development of compensation practices at Fritz Hansen to note, that in 2000 the Balanced Scorecard system was also introduced as an aid for the much needed strategic overhaul – a tool for implementation of newly planned strategic initiatives. In the years since Fritz Hansen's break away from the corporation, a major strategic renewal has indeed taken place. BSC has been the model used for formulation, communication and implementation of the new strategy and its related goals and targets. Fritz Hansen's strategy has thereby changed from being production focused to a strategy of growth and image branding. According to Porter (1980, pp. 38-40) Fritz Hansen utilises a focus strategy, as its products are not affordable for average customers and thereby targets a specific part of the market.

The changes can be seen and felt within the entire organisation. A large part of production has been outsourced and Fritz Hansen has become more brand focused with the birth of Fritz Hansen's brand 'Republic of Fritz Hansen'. This strategic change entails selling more than just furniture by selling an image and lifestyle - Fritz Hansen's mission is to be the international premium brand within design furniture. For this to become a reality, Fritz Hansen has dissolved its sales affiliates and hired 15 plus agents around the world. The focus is on growth in margins and markets share through organic growth. This new growth strategy is called Generation F, and it goes without saying, that there is a great deal of focus on this within the company.

The strategy shift has changed operations and therefore also the firms expectations to managers and other employees. The outsourcing of production has freed up resources for more specialised tasks and this has affected employees, their responsibilities and duties immensely. To be able to live up to the demands that a focus strategy places in a firm, managers experience a high degree of task uncertainty and complexity. The link between input and output is therefore often not clear, as many of the drivers of success are complex and do not have immediate effects. To develop the strategy and attain growth, Fritz Hansen places a strong emphasis on tools such as lean manufacturing, kaisen costing, CRM and new product development. All these processes create a climate of higher complexity and thereby uncertainty in Fritz Hansen, as demands to them becomes more variable.

The development of the compensation package

The new strategy and the changes it has entailed has given rise to the need for an incentive system synonymous with growth, while at the same time motivating employees to move in the same direction. EVA was chosen, since it already played the major role in the rest of the company's coordination and because EVA measures growth, which is one of Fritz Hansen's primary goals. Fritz Hansen utilized the following EVA bonus formula:

$$bonus = target\ bonus + y\%\ (\Delta EVA - EI)$$

Where ΔEVA is the change in EVA since the last time period and EI is expected EVA improvement in the present period. Manager's bonus is therefore their target bonus plus y% (at Fritz Hansen it is 33%) of the change in EVA minus the expected EVA improvement. Thereby managers are compensated for EVA improvement above and beyond the expected. EVA improvement can be positive and negative.

At the time of implementation – in 1999 – it was decided that only the top executive would have compensation tied to EVA, and that other managers would be included over the following two years. In

the two years after implementation, top management experienced success with EVA and the system gave substantial payouts. In 2000-2001, other managers were included in compensation practices and bonus for management makes up 20 percent of their salary. The threshold for compensation tied to EVA was 75 percent meaning that at least 75 percent of bonus must be linked to EVA and the remaining 25 percent could be tied to individual goals, based on the newly implemented BSC.

The individual goals are derived from critical success factors (CSFs), which are formulated by top management every year in their strategy development process. The strategy is translated into CSFs, which are communicated to the departments, where managers can exercise – albeit limited - discretion in mapping their goals to these CSFs. As the CFO of Fritz Hansen states:

> *'What they can do in the departments is develop activities that can be mapped to the critical success factors and that also are goals, so we can see when these activities are reached. The activities are their personal goals.'* CFO

The EVA compensation model at Fritz Hansen utilized of the aforementioned bonus bank system. Bonus is secured by placing a part of payout into the bonus bank and letting the bank's balance – not the present periods performance – determine the bonus that is paid out. The remaining amount stays in the bank as the starting balance for the next period. At the end of every accounting period a percentage of EVA balance is paid out as bonus, while the rest is saved for the next year.

Fritz Hansen thereby introduced the EVA system in a step by step manner, with start-up in 1999. Even though the EVA system was well planned and implemented, external circumstances caused a demotivating effect. This is because, in the first two years that managers where included, no bonus was paid as a consequence of depressed economic conditions, and therefore the plan became unpopular with employees and failed as a motivating factor. As stated by the IT director and member of top management:

> *There was a general dissatisfaction with the compensation system and this was addressed within the executive management. 'What could be done to improve the system?' We decided to implement more emphasis on individual goals'* IT director

After the economic downturn in Denmark in year 2000 and 2001, it was therefore decided to change the minimum level that EVA comprised in bonus plans to from 75 to 50 percent. Employees were given free choice as to whether to include personal goals in compensation plans and therefore the unpopular EVA target was given less emphasis.

All managers at Fritz Hansen are responsible for the achievement of several BSC goals throughout the year. However, these goals are not tied to compensation unless the manager chooses this and even then, it is limited to 50 percent of bonus. The foundation for these goals is set through the BSC system and in essence, managers are responsible mapping their behaviour to a pre-existing strategy, where critical success factors are already defined by top management.

The chosen activities can or cannot be tied to compensation, but are measured through their red, yellow and green status and followed up on via an IT system regardless of inclusion in compensation. Therefore, managers are held responsible for these activities, even if they are not compensated on them. All employees have access to the system, where they can track their own and other employees' progress on all goals – those tied to compensation and those not tied to compensation. Hence, the IT system tracks the company's EVA goals but also all the other BSC activities tied to strategy. Follow up on BSC activities occurs in this system weekly, monthly or yearly depending on the target. In addition, managers are at the end of each year appraised on these measures at a meeting with their superiors.

Despite of the decreased weight that EVA was given after the first year tied to compensation, Fritz Hansen still experienced problems with the EVA plan's contribution to motivation of employees. Since most employees still did not receive bonus payout based in the new bonus weights, it was decided to do away with the bonus bank all together. However the EVA performance measurement was upheld for all employees at Fritz Hansen, as top management still felt that it was a good performance measure. The CFO states:

> *'We could see that the model would not provide any incentives – at least we could calculate for the next 2-4 years. That is what it would take to be about to achieve a bonus again. That would mean that we would have to ask our employees to think in terms of three years or so before bonus became realistic – and we didn't feel that we could do that. You could with top management – but you can't do that with other employees. It's not motivating – it's demotivating.'* CFO

After the removal of the bonus bank, there is nothing in the EVA model to secure managers' focus on long term decision-making.

However, horizon problems are not evident in the company, which does not make sense in an incentive theory perspective.

Analysis

The first research question (see section 0) deals with the company side (why Fritz Hansen designs it compensation system the way it does?) while the second research question deals with the employee side (why are employees motivated by BSC?). Answers will be provided for the two research questions in turn.

Why is the bonus system based on EVA when BSC seems to be more appropriate?

It is a source of wonder that Fritz Hansen partly bases its bonus system on the EVA measure. The contingency variables task uncertainty, business unit strategy and environmental uncertainty do not seem to be able to explain this finding. New contingency variables must be brought into play.

Change urgency

From the story outlined above it is apparent that the EVA measure once had a very dominant position among the measures comprising the performance measurement system at Fritz Hansen. The position of EVA seems somehow to have been retained (although modified) even through times when EVA as a compensation base was not able to motivate employees (during the economic downturn in 2000-2001). Why is it that the EVA is retained when, as top management admits, it should have been abandoned due to demotivating factors? Literature on change argues that a felt need for change such as in a crisis is a prerequisite for change to happen (Burns and Vaivio, 2001). Change urgency is an important ingredient when change is needed.

Let's analyse the level of change urgency within Fritz Hansen. From the interviews it becomes clear that although bonus is based on EVA employees do not behave accordingly (see also the analysis in relation to research question 2). It could be expected that employees were not motivated by a measurement system that emphasises a lagging indicator when a clear understanding of the input-output relation is not present. But rather than being frustrated the employees are motivated by the BSC measures. Thus, the behaviour of the employees is still in the interest of the company and therefore the level of change urgency with regard to EVA and the bonus system was relatively low.

Although change urgency is not a new variable to the change literature it is so to contingency theory.

An ultimate goal

What is particularly appealing with EVA is that it seems synonymous with Fritz Hansen's ultimate goal. The measure is able to summarise the final outcome of all actions, that is, all BSC goals as well as the Generation F strategy. With this one measure one does not need to worry about other measures because more EVA will always mean more value for shareholders (Young and O'Byrne 2001, pp. 321-323). Top management of Fritz Hansen seems to have been persuaded by this argument. Therefore, by retaining the EVA top management hopes to be able to keep it simple.

The inherent power or persuading ability of a measure seems to be an explanatory variable in the case of Fritz Hansen. This variable is different from that of fashion or fad (DiMaggio and Powell, 1983) in that the power of the measure is determined independently of external constituents. It is the appeal of the measure that could explain why Fritz Hansen retains EVA as a basis for determining the size of the bonus.

The legitimising effect

Although typically regarded a variable in the context of institutional theory (e.g. DiMaggio and Powell, 1983) the legitimising effect of the EVA measure also seems to have a say in the case of Fritz Hansen. Originally, the EVA measure was implemented as a response to the holding company's request. But although EVA was implemented on that basis, the measurement system is not left unused in that Fritz Hansen actively uses it as a management accounting tool. Thus, the negative side of legitimisation where the organisation uses the tool to as limited an extent as possible is not what we find here.

While legitimacy was a driver for the implementation of EVA back when Fritz Hansen was a subsidiary of a holding company, legitimacy is to at lesser extent a driver today since no demanding shareholder exists. But some degree of legitimisation is still present in relation to the board of directors. In relation to the bonus bank system, the following argument of legitimacy was used by Fritz Hansen CFO:

> *'The bonus bank is a good thing for top management, who need to be able to prove for the board of directors, that we have reached long term goals [i.e. created growth and value].'* CFO

This is an argument of legitimacy, since EVA is seen as a legitimate tool to prove the creation of value.

Do we experience a situation of equilibrium?

In order for the search for explanatory variables to be meaningful it is a requirement that Fritz Hansen is in a situation of equilibrium. If this is not the case and if EVA as basis for compensation is removed after a while then the need to explain this temporary situation seems to be reduced.

EVA as a basis for compensation has been around for long time within Fritz Hansen. The measure was first introduced in 1999 and today – seven years later – it still is an important measurement system. Therefore, use of EVA at Fritz Hansen does not seem to be a temporary situation – unless you subscribe to a view on change in which no equilibrium is expected to exist. This is not the assumption that we and contingency theory in general uphold. On the other hand, from the interviews and the site visits we somehow sense that EVA is not going go stay forever at Fritz Hansen as a basis for bonus calculation. If this feeling has roots in reality then our research is of limited value.

Why are employees motivated by BSC measures while rewarded on EVA?

At Fritz Hansen managers are in large part motivated by BSC measures, even though they are not compensated on these. The shortsightedness associated with removal of the bonus bank has perhaps been minimised by the presence of the BSC system. In effect BSC measures at Fritz Hansen seem to mitigate the shortsightedness that removal of the bonus bank - according to compensation theory - normally causes.

The BSC measures chosen are well linked in a causal manner to strategy – which in essence – is the company's long term goal. This is assured through the CSFs linked to strategy which are cascaded through the organisation and to which managers link their BSC goals. In addition, the BSC measures that managers have responsibility for are leading measures for EVA, which is the lagging measurement for Fritz Hansen's Generation F strategy and thereby the overall lagging measure at Fritz Hansen. In this manner, long term BSC measures replace the bonus bank's role in encouraging longtermedness with managers – through their explicit link to strategy.

But a link to the strategy is not enough – the link must be translated throughout the organisation by motivating the desired behaviour from managers (Kaplan and Norton, 2001, p. 240). BSC measures and managerial behaviour are linked through the measurement system that Fritz Hansen employs. The IT system is implemented to follow up on BSC measures in real time and is widely used at Fritz Hansen. Managers can, at any given time, track their and other employees' progress on BSC measures, including EVA, which is Fritz Hansen's ultimate lagging goal. In this manner the measurement mechanism replaces the compensation tie between management decision making and goal setting. The system helps to support the linkages between BSC measures and strategy by mapping it out in a graphic manner that all employees have access to. The IT system is thereby a contingency variable which links manager's input with output in a visual manner, but also links managerial input to the fulfilment of Fritz Hansen's ultimate output – realising the overall business strategy.

Many managers at Fritz Hansen are of the opinion that their BSC goals are more closely linked to strategy than EVA. This can be explained by the explicit set of causal relations between strategy and BSC goals that define the system. Since the managers can see the links connecting their actions to long term strategy, their task uncertainty is minimised. That is, managers can trace their BSC activities to value creation through their BSC activities, leading indicators to the ultimate goal of company, creation of EVA. Thereby managers become more aware of how their input (BSC activities) produces an output (creation of EVA).

In addition, because BSC also takes into account non-financial measures, then managerial performance is more broadly defined than, for example, when measuring strictly on financial measures. The window of opportunity to create value for the company is larger when non-financial measures are included. When task uncertainty is high and processes are complex, as in Fritz Hansen, this can have the effect of minimising task uncertainty. This is because managers feel that the scope of their performance evaluation encompasses all their tasks, not just the ones expressed through financial measures.

In addition, BSC activities are leading indicators that managers often have more direct control over than EVA growth and this can, according to the controllability principle (Solomons, 1983), increase motivation. The controllability aspect is a contingency factor that can explain why managers are motivated by activities that are not linked to compensation. Managers' pick their BSC activities, but their opportunity to manipulate this choice by picking goals according to their own personal desires and in conflict with the firms strategy is limited. This is because managers must map their activities to pre-existing critical success factors that top management has aligned with strategy. Therefore, the top down process utilised by top management to align managerial decision making with their wishes is a contingency factor that is an integral part of ensuring the system's success. This contingency variable limits managerial discretion in choosing activities that can work against organisational strategy is therefore limited.

In 2005 market conditions in Denmark were aligned with EVA growth and Fritz Hansen over performed on EVA in accounting period 2004/2005. Although not the only factor leading to EVA growth, demand conditions effecting positive development in sales is a main catalyst. Therefore, it would be expected that managers choose full EVA compensation, but this was not the case in Fritz Hansen. Most managers picked to include BSC goals in compensation instead of 100 percent EVA compensation. This trend can be explained through the controllability principle (Solomons, 1983), since managers pick goals which they feel they can control and thereby fulfil. The fulfilment issue does not explicitly carry rewards because there is no tie to compensation. However, managers feel motivated to choose there measures.

This can be explained by the fact that although not directly linked to rewards and punishments, there is a performance evaluation process for all goals at Fritz Hansen. At annual employee appraisals managers go through a follow up on performance on all measures. Because the measurement system has been following progress throughout the year, the review is not a subjective judgement of the employee's performance. Rather, at the annual appraisal performance is a given and both goals tied directly to bonus through compensation plans as well as activities outside of this plan are followed up on. In

Fritz Hansen the distinction by managers between bonus and non-bonus targets is therefore not as relevant in their decisions as the controllability principle.

There are several contingency variables that help ensure the success of the compensation system at Fritz Hansen. These are the measurement system, the IT system, which creates a link between managerial actions and fulfilment of strategy – thereby mapping input/output variables for managers. In addition, the BSC measures can decrease task uncertainty because non financial measures are included, thereby broadening the scope of managerial performance. The inclusion of non-financial measures widens the scope for how managerial task contribute to the companies success. This is because the links between performance measurement and creation of value (output) are inherent in the BSC approach. The top down process in cascading the BSC critical success factors in the organisation is a contingency variable which controls managerial discretion and thereby their ability to game the compensation system at Fritz Hansen. The controllability principle is a contingency variable that explain why managers are motivated by BSC measures and why they choose these measures, even in times when the choice of EVA measure will most likely ensure bonus pay out.

These variables ensure the success of the compensation system in Fritz Hansen. The BSC system and the contingency variables are alternative explanations that traditional agency based compensation theory do not include. Thereby the case challenges traditional compensation theory and contingency theory supplements the traditional agency theory view with this case contribution.

Conclusion

The case study at Fritz Hansen has proven an interesting research topic for identifying alternative explanations of managerial behaviour to incentives theory. In addition, the case has helped identify key contingency variables as explanation for this behaviour – thereby expanding contingency theory on compensation systems. The contingency variables found to influence behaviour at Fritz Hansen includes change urgency, the presence of an ultimate lagging goal, the legitimising effect, the system of measurement, non-financial measurement and lastly the controllability principle.

The analysis was split into to research questions - the first question addressing the issue of why Fritz Hansen utilises EVA when, according to contingency theory, it should use BSC measures. The contingency variables explaining why Fritz Hansen utilises EVA instead of BSC are change urgency, presence of an ultimate EVA goal and the legitimising effect. There is not a great need for change in the system at Fritz Hansen because at present, managers act in the interest of top management – the old saying comes to mind 'If its not broke, why fix it?' This meaning that if the outcome of a compensation system is to align top management and lower management's interests, then the current system does this – therefore there is no urgency for change.

In addition, the EVA measure is a good fit with the organisations long term growth strategy – thereby encompassing the ultimate goal of the company. Since EVA is synonymous with growth, this can be a reason for keeping the measure. Lastly a variable explaining Fritz Hansen's choice of EVA in relation to compensation is legitimisation – EVA is a tool that the board of directors understands and which communicates that, which top management wishes.

In relation to why managers are motivated by measures, that they are not compensated on, there are several factors that explain this. The performance measurement system at Fritz Hansen is a variable that make input/output variables and their interrelationship clearer and this motivates managers. In addition, task uncertainty is minimised at Fritz Hansen by the plethora of measures, also non-financial, that are tied to BSC and this can explain why managers are more motivated by this than EVA – where the link between action and outcome is not as clear.

Managers also are of the opinion that they can influence BSC measures more than EVA and thereby the controllability variable is also an explanation of behaviour. This also explains why managers choose BSC measures over EVA, even when market conditions almost guarantee bonus payout based on EVA. Lastly, the top down process in Fritz Hansen is a variable, which explain how it is hard for managers to game the system. The BSC activities that managers choose must be mapped to pre-existing critical success factors and therefore management discretion and the possibility for opportunistic behaviour is reduced.

As with all studies this is also subject to limitations. The case study method has been very useful for this study since it has enabled us to extract variables not found using other research methods. But with the case study method it is not possible or the intention to generate generalisable findings (Yin, 1994, p. 30). Therefore, test of the external validity of the findings is still outstanding.

Another limitation is inherent of the issue of equilibrium. Whether Fritz Hansen is in equilibrium or not can be subject to discussion, and if readers do not feel persuaded that Fritz Hansen is in a state of equilibrium then the study offers only limited theoretical contributions.

The study tries to enrich contingency theory by adding new variables that can explain i) why EVA is kept as a measure and ii) why managers behave according to BSC measures while rewarded on EVA. Several variables were found as summarised above. Some of these variables are taken from other grand theories such as the variable legitimisation, which is a typical variable of institutional theories. We do not believe that different grand theories are incommensurable. We would therefore as an avenue

for further research like to propose that cases like Fritz Hansen are approached from several perspectives. In this way strengths of different grand theories are made use of and weaknesses are covered for. When using several grand theories it is required that researchers are especially aware of differing assumptions that lie behind the theories and that different grand theories are not mixed.

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