MANAGERIAL APPLICATIONS

Benchmarking the Lincoln Electric Company

Lincoln Electric company has had a long history of delivering large profits. Often, this record is attributed to Lincoln's unique reward system, which places a heavy emphasis on incentive compensation (we describe this system in detail in Chapter 13). Managers from all over the world come to the Lincoln Electric headquarters at Cleveland, Ohio, to study the system. Our analysis suggests that these managers should consider Lincoln's business environment, strategy, and other elements of organizational architecture (for instance, its decision-right system) in their benchmarking. Lincoln's success should not be attributed to its reward system alone but to how well this feature fits with its environment and overall architecture.

Interestingly, Lincoln managers made the costly mistake of ignoring the complementary nature of these systems themselves. During the 1980s, the management at Lincoln decided to export its incentive system internationally through a series of mergers throughout Europe, Asia, and Latin America. Unfortunately, the system did not fit the business environments at many of their new locations. For instance, the influence of unions in Germany and labor laws in Venezuela made it impossible for Lincoln to implement its compensation system successfully. Lincoln ended up losing millions of dollars on these ventures. Lincoln might have avoided these mistakes if in its decision-making process it had applied carefully the framework discussed in this book.

Once jobs are created, firms must design reward systems that will attract and retain qualified individuals. Chapter 14 analyzes the level of pay and the components of the compensation package—the mix between salary and fringe benefits. The focus in this chapter is how to design pay packages that allow firms to attract and retain qualified employees at the lowest cost. Although the level of pay attracts individuals to jobs, incentive compensation generally provides a primary motivation for employees to complete the assigned tasks. Chapter 15 provides a detailed analysis of incentive compensation.

Incentive plans base their payoffs on measures produced by the performance-evaluation system. Chapter 16 focuses on performance measurement of individual employees, while Chapter 17 examines performance measurement of subunits within the firm—for example, divisions and subsidiaries.

ANALYZING MANAGERIAL DECISIONS: *Eastman Kodak*

For many years, Eastman Kodak had a virtual monopoly in film production. This market power resulted in large profits. It also permitted Kodak to control the timing for introducing new products to the marketplace and responding to changes in consumer demands.

By the 1980s, Kodak's market environment had changed materially. The Fuji Corporation produced high-quality film that eroded Kodak's market share. Increased competition also came from generic store brands. In addition, the 1980s witnessed a technological explosion. Improved communications, design capabilities, and robotics allowed companies to bring new products to market within months rather than years.

These changes in the market environment placed significant pressure on Kodak. Kodak's stock price dropped from over $85 per share in 1982 to just over $71 in 1984. This 16 percent decline in stock price appears particularly dramatic when it is compared to the substantial increase in stock prices for the market as a whole. Earnings per share at Kodak also dropped substantially. The company realized it had to change its organization to regain profits and market share. To quote Colby Chandler, former CEO of Kodak, at the 1984 annual meeting:

> *Like many companies, we are not used to working in an environment where there is rapid technological transfer from laboratory to the marketplace. But we know that will be important in our future.*

During 1984, Kodak undertook a major corporate restructuring. Prior to the restructuring, decision making at Kodak was quite centralized. Top-level approval was required for most major decisions. The restructuring created 17 new business units with profit-and-loss responsibility. Business-unit managers were given increased decision-making authority for new products, pricing, and other important policy choices. By decentralizing decision rights, senior management hoped to make the company more responsive to changing customer demands and market conditions. To quote the 1984 annual report:

> *In short, Kodak is finding new ways to stimulate the innovative nature of its people. The result: a spirit of independence, new ideas and a quickened pace in the process which turns new ideas into commercial realities.*

Unfortunately for Kodak, changing the *assignment of decision rights* did not have a significant impact on the company's performance. In response, Kodak adopted the Management Annual Performance Plan (MAPP) in 1987. Under this plan, the base salary of management employees was reduced by 10 percent and replaced with a variable bonus. The bonus was to average 10 percent, ranging from 0 to 20 percent. Bonus payments were based on individual, unit, and company objectives.

The idea behind MAPP was that changing the *performance-evaluation and reward systems* would motivate managers to be more creative and industrious. The plan, however, did not have a large impact on managerial incentives or corporate profits. In 1993, Kodak officials were quoted as saying (1) that management had not really been held accountable for its failure to deliver results, (2) that management had to develop tougher work standards and demote failing employees, and (3) that in the past, managers who advanced at Kodak had excelled in office politics but not necessarily leadership.* Frustrated by the continued lack of success, Kodak's board of directors fired its CEO in late 1993.

1. What factors motivated Kodak to change its organizational architecture?
2. What mistakes did Kodak make in changing its architecture?
3. What might it have done differently?
4. How does this example relate to the concept of economic Darwinism?

**Democrat and Chronicle* (June 27, 1993).

Summary

Organizational architecture includes three important components of organizational design that are major determinants of the success or failure of firms:

- The assignment of decision rights
- The methods of rewarding individuals
- The structure of systems to evaluate the performance of both individuals and business units

The fundamental problem facing both firms and economic systems involves trying to ensure that decision makers have the relevant information to make good decisions and that these decision makers have appropriate incentives to use their information productively. The price system provides an architecture that helps solve this problem in markets. Through market transactions, decision rights tend to be transferred to individuals with the relevant knowledge to make productive use of the resources. The market