COMPENSATION MANAGEMENT

CHAPTER 9 (Study unit 8)
Pay-for-Performance

UNISA college of economic and management sciences

Chapter Topics

- What Behaviors Do Employers Care About?
- What Does It Take to Get These Behaviors? What Theory and Research Say
- What Does It Take to Get These Behaviors? What Compensation People Say
- Total Reward System: Besides Money, Other Rewards Influence Behavior!
- Does Compensation Motivate Behavior? General Comments
- Does Compensation Motivate Behavior? Specific Comments
- Designing a Pay-for-Performance Plan
- Your Turn: Burger Boy

What Behaviors Do Employers Care About?

- Employers want employees to perform in ways that lead to better organizational performance
- Organizational strategy is the guiding force that determines what kinds of employee behaviors are needed
- Behaviors that compensation needs to reinforce
  - Compensation should be sufficiently attractive to make recruiting and hiring good potential employees possible (attraction)
  - Need to make sure the good employees stay with the company (retention)
  - Need to find ways to motivate employees to perform well on their jobs—to take their knowledge and abilities and apply them in ways that contribute to organizational performance

Exhibit 9.1: The Cascading Link between Organization Strategy and Employee Behavior

EXHIBIT 9.1 **The Cascading Link between Organization Strategy and Employee Behavior**

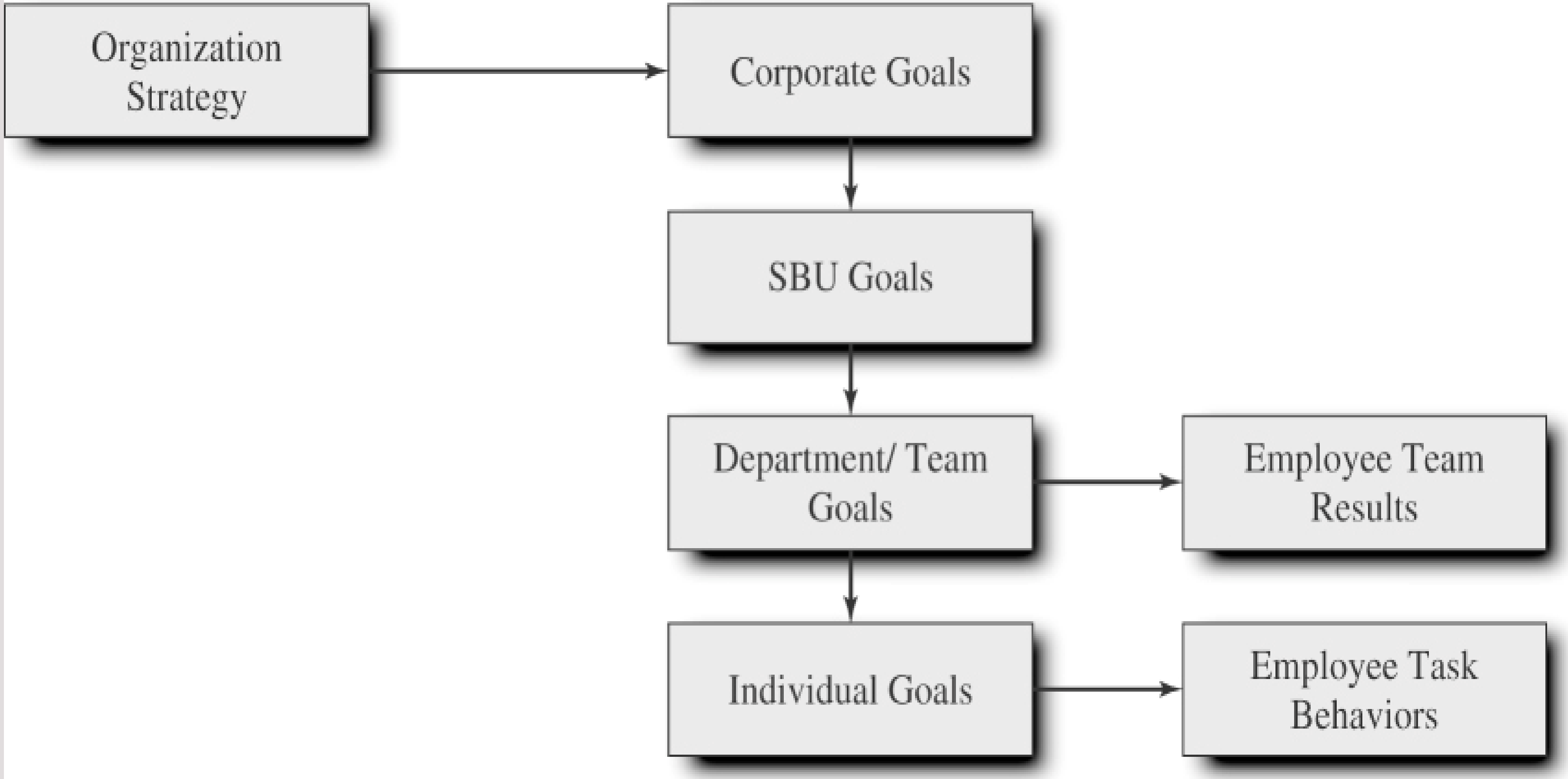

Exhibit 9.2: The Big Picture, or Compensation Can't Do It Alone!

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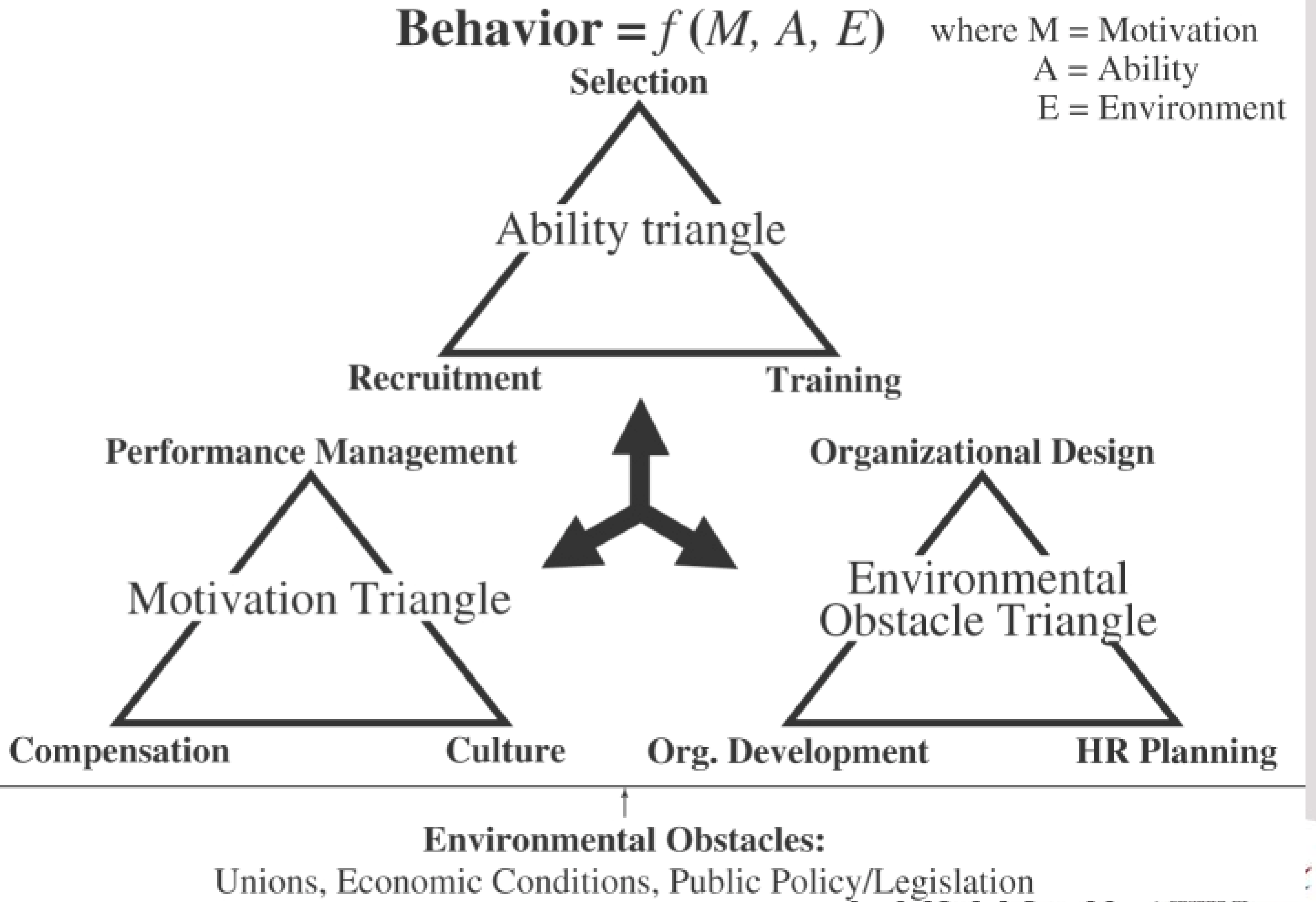
The Big Picture, or Compensation Can't Do It Alone!



What Behaviors Do Employers Care About? (cont.)

- Performance measurement
  - Need to accurately measure performance to tell if compensation efforts are working
- Performance management
- How do we get good employment prospects to ***join*** our company?
- How do we ***retain*** these good employees once they join?
- How do we get employees to ***develop skills*** for current and future jobs?
- How do we get employees to ***perform well*** on their current job?

Exhibit 9.3 Performance Measurement Relates to Compensation Strategy

EXHIBIT 9.3 Performance Measurement Relates to Compensation Strategy

		Variability in Organizational Performance	
		Low variability: Few swings in overall corporate performance	**High variability: Regular and large swings in overall corporate performance**
Variability/ ease of measurement in individual performance	**Unstable, unclear, and changing objectives**	Cell A—provide wide range of rewards beyond just money. Include significant incentive component.	Cell B—provide wide range of rewards beyond just money. Emphasize base pay with low-incentive portion.
	Stable and easily measured	Cell C—emphasize monetary rewards with large-incentive component.	Cell D—emphasize monetary rewards: large base pay with low-incentive portion.

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What Motivates Employees?

- In the simplest sense, motivation involves three elements:

  1. What is important to a person?

  2. Offering it in exchange for some

  3. Desired behavior

- Refer to Exhibit 9.4 in the prescribed book regarding the different motivation theories

What Compensation People Say

- Employees learned what behaviors were important as part of the socialization process

- Compensation is designed to support this risk-taking behavior

  - Total Reward System

    - Compensation is but one of many rewards that influence employee behavior

Exhibit 9.5: Components of a Total Reward System

EXHIBIT 9.5 Components of a Total Reward System

1. Compensation	Wages, commissions, and bonuses
2. Benefits	Vacations, health insurance
3. Social interaction	Friendly workplace
4. Security	Stable, consistent position and rewards
5. Status/recognition	Respect, prominence due to work
6. Work variety	Opportunity to experience different things
7. Workload	Right amount of work (not too much, not too little)
8. Work importance	Is work valued by society
9. Authority/control/autonomy	Ability to influence others; control own destiny
10. Advancement	Chance to get ahead
11. Feedback	Receive information helping to improve performance
12. Work conditions	Hazard free
13. Development opportunity	Formal and informal training to learn new knowledge skills/abilities

Exhibit 9.6: Wage Components

EXHIBIT 9.6 Wage Components

Wage Component	Definition	Level of Risk to Employee
Base pay	The guaranteed portion of an employee's wage package.	As long as employment continues, this is the secure portion of wages.
Across the board	Wage increase granted to all employees, regardless of performance. Size related to some subjective assessment of employer about ability to pay. Typically an add-on to base pay in subsequent years.	Some risk to employee since at discretion of employer. But not tied to performance differences, so risk lower in that respect.
Cost-of-living increase	Same as across-the-board increase, except magnitude based on change in cost of living (e.g., as measured by CPI).	Same as-across-the-board increases.
Merit pay	Wage increase granted to employee as function of some assessment of employee performance. Adds on to base pay in subsequent years.	Two types of risk faced by employees. Size of total merit pool at discretion of employer (risk element), and individual portion of pool depends on performance, which also is not totally predictable.
Lump-sum bonus	As with merit pay, granted for individual performance. Does not add into base pay, but is distributed as a one-time bonus.	Three types of risks faced here. Both types mentioned under merit pay, plus not added into base—requires annually "re-earning" the added pay.
Individual incentive	Sometimes this variable pay is an add-on to a fixed base pay. The incentive component ties increments in compensation directly to extra individual production (e.g., commission systems, piece rate). While measures of performance are typically subjective with merit and lump-sump components, this form of variable pay differs because measures of performance are objective (e.g., sales volume).	Most risk compensation component if sole element of pay, but often combined with a base pay. No or low fixed-base pay means each year employee is dependent upon number of units of performance to determine pay.
Success-sharing plans	A generic category of pay add-on (variable pay) which is tied to some measure of group performance, not individual performance. Not added into base pay. Distinguished from risk-sharing plans, below, because employees share in any success—performance above standard—but are not penalized for performance below standard.	All success-sharing plans have risks noted in above pay components plus the risk associated with group performance measures. Now individual worker is also dependent upon the performance of others included in the group.

Exhibit 9.6: Wage Components (con't)

Wage Component	Definition	Level of Risk to Employee
• Gain sharing	Differs from profit sharing in that goal to exceed is not financial performance of organization but some cost index (e.g., labor cost is most common, might also include scrap costs, utility costs).	Less risk to individual than profit sharing because performance measure is more controllable.
• Profit sharing	Add-on linked to group performance (team, division, total company) relative to exceeding some financial goal.	Profit measures are influenced by factors beyond employee control (e.g., economic climate, accounting write-offs). Less control means more risk.
Risk sharing plans	Generic category of pay add-on (variable pay) that differs from success sharing in that employee not only shares in the successes but also is penalized during poor performance years. Penalty is in form of lower total compensation in poor corporate performance years. Reward, though, is typically higher than that for success-sharing programs in high performance years.	Greater risk than success-sharing plans. Typically, employees absorb a "temporary" cut in base pay. If performance targets are met, this cut is neutralized by one component of variable pay. Risk to employee is increased, though because even base pay is no longer totally predictable.

Does Compensation Motivate Behavior? Specific Comments

- Do people ***join*** a firm because of pay?
- Do people ***stay*** in a firm (or leave) because of pay?
- Do employees more readily agree to ***develop job skills*** because of pay?
- Do employees ***perform better*** on their jobs because of pay?

Do People Join a Firm Because of Pay?

- Key factors affecting a person’s decision to join a firm
  - Level of pay
  - Pay system characteristics
- Job candidates look for organizations that “fit” their personalities
- Reward systems should be designed to attract people with desired
  - Personalities
  - Values

Do People Stay in a Firm (Or Leave) Because of Pay?

- Factors impacting turnover
  - Pay based on individual performance
  - Group incentive plans
  - Level of employee satisfaction with pay
  - Type of pay system

- Other rewards affect the decision to stay
  - Work variety and challenge
  - Development opportunity
  - Social
  - Status recognition
  - Work importance
  - Benefits

Do Employees More Readily Agree to Develop Job Skills Because of Pay?

- Evidence is unclear
- Relevance of skill-based pay

Do Employees Perform Better on Their Jobs Because of Pay?

- Not clear if performance of individuals can be increased by tying it to pay
- If the incentive depends on individual performance, applicants find the company more attractive
- Team-based incentives, in contrast, are less attractive
- A number of recent studies provide strong evidence that pay for performance has a direct and, at times, substantial impact on firm performance

Exhibit 9.7: Examples of Group Incentive Plans

EXHIBIT 9.7
Examples of Group Incentive Plans

Company	Pay Component
Corning	Competitive base pay. Group bonus based on meeting certain quality measures, customer satisfaction measures, and production targets.
Nucor	Plant manager base pay 25 percent below market. Five percent of excess over target goes to bonus. Bonus often equals base pay in amount.
PepsiCo	Competitive base pay. All employees get stock options equal to 10 percent of base pay. Employees share in corporate triumphs and failures as stock prices rise or fall.

Designing A Pay-For-Performance Plan

- ***Efficiency***
  - Strategy: does the pay-for-performance plan support corporate objectives? Does it link well with HR strategy and objectives?
  - Structure: is the structure of the organisation sufficiently decentralized to allow different operating units to create flexible variations on a general pay-for-performance plan?
  - Standards
    - Objectives
    - Measures
    - Eligibility
    - Funding

Designing A Pay-For-Performance Plan (cont.)

- Equity/Fairness
  - Distributive justice: amount that is distributed to employees, does the employee view it as fair?
  - Procedural justice: Was a fair procedure used to determine the amount of rewards employees receive?
  - Communications is key in fairness
- Compliance
  - Comply with existing laws
  - Enhance and maintain firm’s reputation

Your turn

Answer the end of chapter 9 review questions