



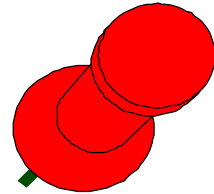
# COMPENSATION MANAGEMENT

## CHAPTER 10 (Study unit 8) Pay-for-Performance Plans

# Chapter Topics

- What Is a Pay-for-performance Plan?
- Does Variable Pay Improve Performance Results? The General Evidence
- Specific Pay-for-performance Plans: Short Term
- Team Incentive Plans: Types
- Explosive Interest in Long-term Incentives

# What Is Pay-for-Performance?



**Pay for performance plans signal  
a *movement away* from  
*entitlements***

**Pay will vary with some measure  
of individual, team, or  
organizational performance**

# Overview: Pay-for-Performance Plans

- Types of plans
  - Use of Different Variable- Pay-Plan Types
  - Base vs. Variable Pay
- Increasing interest in variable pay
  - Competition from foreign competitors
  - Fast-paced business environment

# Specific Pay-for-Performance Plans: Short Term

- Merit Pay
- Lump-Sum Bonuses
- Individual Spot Awards
- Individual Incentive Plans

# Merit Pay

- A merit pay system links increases in base pay to how highly employees are rated on a subjective performance evaluation
- An employee is evaluated at the end of the performance year
- Issues
  - Expensive
  - Doesn't achieve the desired goal: improving employee and corporate performance

# Managing Merit Pay

- Improve accuracy of performance ratings
- Allocate enough money to truly reward performance
- Make sure size of merit increase differentiates across performance levels

# Lump-Sum Bonuses

- Increasingly used substitute for merit pay
- Not built into base pay: based on employee/company performance
- Viewed as less of an entitlement than merit pay because employees need to earn it
- Less expensive than merit pay over the long run
- Employees not fond of lump-sum bonuses: by giving lump-sum bonuses for several years, a company is essentially freezing base pay



# Individual Spot Awards

- Viewed as highly or moderately effective
- Typically awarded for exceptional performance
  - Special projects
  - Exceptional performance

# Overview: Individual Incentive Plans

- Offer a promise of pay for some objective, pre-established level of performance
- **Common feature** - An established standard against which employee performance is compared to determine magnitude of incentive pay

# Exhibit 10.5: Individual Incentive Plans

## EXHIBIT 10.5 Individual Incentive Plans

		Method of Rate Determination	
		<i>Units of production per time period</i>	<i>Time period per unit of production</i>
<b>Relationship between Production Level and Pay</b>	<i>Pay constant function of production level</i>	(1) Straight piecework plan	(2) Standard hour plan
	<i>Pay varies as function of production level</i>	(3) Taylor differential piece-rate system Merrick multiple piece rate system	(4) Halsey 50-50 method Rowan plan Gantt plan

# Individual Incentive Plans: Types

- Standard is compared against individual worker performance
- Dimension on which incentive systems vary
  - Method of rate determination
  - Specified relationship between production level and wages

# Exhibit 10.7: A Straight Piece Rate Plan

## **EXHIBIT 10.7** **A Straight** **Piece Rate** **Plan**

Piece rate standard (e.g., determined from time study): 10 units/hour  
Guaranteed minimum wage (if standard is not met): \$5/hour  
Incentive rate (for each unit over 10 units): \$.50/unit

### **Worker Output**

### **Wage**

10 units or less

\$5.00/hour (as guaranteed)

20 units

$20 \times \$.50 = \$10/\text{hour}$

30 units

$30 \times \$.50 = \$15/\text{hour}$

# Advantages of Individualized Incentive Plans

- Substantial contribution to:
  - Productivity raise
  - Lower production costs
  - Workers earnings
- Reduces direct supervision to maintain reasonable output levels
- Enables labor costs to be estimated more accurately than under payment by time
  - Helps costing and budgetary control

# Disadvantages of Individualized Incentive Plans

- Conflicts may emerge between employees managers
- Introduction of new technology may be resisted by employees
- Reduced willingness of employees to suggest new production methods
- Increased complaints of poor maintenance, hindering employee efforts to earn larger incentives
- Increased turnover among new employees discouraged by the unwillingness of experienced workers to cooperate in on-the-job training
- Elevated levels of mistrust between workers and management

# Exhibit 10.10: Lincoln Electric's Compensation System

## EXHIBIT 10.10 Lincoln Electric's Compensation System

Description of culture	Reservoir of trust. Long history of employment stability even during severe economic downturns. Employees with 3+ years' seniority are guaranteed (on 1 year renewable basis) at least 75 percent full-time work for that year. In exchange, employees agree to flexible assignment across jobs.
Base wages	Market rate determined. Time study department sets piece rate so that average worker can earn market rate.
Bonus (short term)	Board of directors sets year-end bonus pool as function of company performance. Employee's share in pool is function of semiannual performance review (see below).
Incentive (long term)	Employees share in long-term company successes/failures in form of employee stock ownership plan (ESOP). Employees now own 28 percent of outstanding stock shares.
Performance review	Employees rated on four factors: (1) dependability, (2) quality, (3) output, (4) ideas and cooperation in comparison to others in department. To ensure against rating inflation, the average score in department cannot exceed 100.



# Overview of Team Incentives

- Improve organizational performance
- Use organizational measures
- Measured periodically

# Exhibit 10.11: A Sampling of Performance Measures

## EXHIBIT 10.11 A Sampling of Performance Measures

### Customer-Focused Measures

#### Time-to-Market Measures

- On-time delivery
- Cycle time
- New product introductions

#### Customer Satisfaction Measures

- Market share
- Customer satisfaction
- Customer growth and retention
- Account penetration

### Capability-Focused Measures

#### Human Resource Capabilities

- Employee satisfaction
- Turnover rates
- Total recruitment costs
- Rate of progress on developmental plans
- Promotability index
- Staffing mix/head-count ratio

#### Other Asset Capabilities

- Patents/copyrights/regulations
- Distribution systems
- Technological capabilities

### Financially Focused Measures

#### Value Creation

- Revenue growth
- Resource yields
- Profit margins
- Economic value added

#### Shareholder Return

- Return on invested capital
- Return on sales/earnings
- Earnings per share
- Growth in profitability

### Internal Process-Focused Measures

#### Resource Utilization

- Budget-to-actual expenses
- Cost-allocation ratios
- Reliability/rework
- Accuracy/error rates
- Safety rates

#### Change Effectiveness

- Program implementation
- Teamwork effectiveness
- Service/quality index

# Balanced Scorecard Approach

- Uses a *constellation* of measures
  - Pinpoints areas of success
  - Indicates areas to improve
- *Categories* of measures
  - Financial results
  - Process improvements
  - Customer service
  - Innovation
- Forces discussions about priorities among different measures
- *Outcome* – Objectives with different weights in terms of importance

# Exhibit 10.12: Types of Variable Pay Plans: Advantages and Disadvantages

## EXHIBIT 10.12 Types of Variable-Pay Plans: Advantages and Disadvantages

Source: Kenan S. Abosch, "Variable Pay: Do We Have the Basics in Place?" 30(4) 1998, pp.12-22.

Plan Type	What Is It?	Advantages	Disadvantages	Why?
Cash profit sharing	<ul style="list-style-type: none"> <li>• Award based on organizational profitability</li> <li>• Shares a percentage of profits (typically above a target level of profitability)</li> <li>• Usually an annual payout</li> <li>• Can be cash or deferred 401(k)</li> </ul>	<ul style="list-style-type: none"> <li>• Simple, easily understood</li> <li>• Low administrative costs</li> </ul>	<ul style="list-style-type: none"> <li>• Profit influenced by many factors beyond employee control</li> <li>• May be viewed as an entitlement</li> <li>• Limited motivational impact</li> </ul>	<ul style="list-style-type: none"> <li>• To educate employees about business operations</li> <li>• To foster teamwork or "one-for-all" environment</li> </ul>
Stock ownership or options	<ul style="list-style-type: none"> <li>• Award of stock shares or options</li> </ul>	<ul style="list-style-type: none"> <li>• Option awards have minimal impact on the financial statements of the company at the time they are granted</li> <li>• If properly communicated, can have powerful impact on employee behavior</li> <li>• Tax deferral to employee</li> </ul>	<ul style="list-style-type: none"> <li>• Indirect pay/performance link</li> <li>• Employees may be required to put up money to exercise grants</li> </ul>	<ul style="list-style-type: none"> <li>• To recruit top-quality employees when organization has highly uncertain future (i.e., start-ups, high-tech, or biotech industries)</li> <li>• To address employee retention concerns</li> </ul>
Balanced scorecard	<ul style="list-style-type: none"> <li>• Awards that combine financial and operating measures for organization, business unit, and/or individual performance</li> <li>• Award pool based on achieving performance targets</li> </ul>	<ul style="list-style-type: none"> <li>• Communicates organizational priorities</li> </ul>	<ul style="list-style-type: none"> <li>• Performance criteria may be met, but if financial targets are not met, there may be a reduced payout or no payout at all</li> <li>• Can be complex</li> </ul>	<ul style="list-style-type: none"> <li>• To focus employees on need to increase shareholder value</li> <li>• To focus employees on organization, division, and/or individual goals</li> <li>• To link payouts to a specific financial and/or operational target</li> </ul>

# Exhibit 10.12: Types of Variable Pay Plans: Advantages and Disadvantages-con't

Plan Type	What Is It?	Advantages	Disadvantages	Why?
Productivity/ gain sharing	<ul style="list-style-type: none"> <li>Multiple performance measures may include:                             <ol style="list-style-type: none"> <li>Nonfinancial/operating: quality improvements, productivity gains, customer service improvements</li> <li>Financial: EPS, ROE, ROA, revenues</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>Clear performance–reward links</li> <li>Productivity and quality improvements</li> <li>Employee's knowledge of business increases</li> <li>Fosters teamwork, cooperation</li> </ul>	<ul style="list-style-type: none"> <li>Can be administratively complicated</li> <li>Unintended effects, like drop-off in quality</li> <li>Management must "open the books"</li> <li>Payouts can occur even if company's financial performance is poor</li> </ul>	<ul style="list-style-type: none"> <li>To support a major productivity/quality initiative (such as TQM or reengineering)</li> <li>To foster teamwork environment</li> <li>To reward employees for improvements in activities that they control</li> </ul>
Team/group incentives	<ul style="list-style-type: none"> <li>Awards determined based on team/group performance goals or objectives</li> <li>Payout can be more frequent than annual and can also extend beyond the life of the team</li> <li>Payout may be uniform for team/group members</li> </ul>	<ul style="list-style-type: none"> <li>Reinforces teamwork and team identity/ results</li> <li>Effective in stimulating ideas and problem-solving</li> <li>Minimizes distinctions between team members</li> <li>May better reflect how work is performed</li> </ul>	<ul style="list-style-type: none"> <li>May be difficult to isolate impact of team</li> <li>Not all employees can be placed on a team</li> <li>Can be administratively complex</li> <li>May create team competition</li> <li>Difficult to set equitable targets for all teams</li> </ul>	<ul style="list-style-type: none"> <li>To demonstrate an organizational commitment to teams</li> <li>To reinforce the need for employees to work together to achieve results</li> </ul>

# Exhibit 10.13: The Choice Between Individual and Group Plans

## EXHIBIT 10.13 The Choice between Individual and Group Plans

Characteristic	Choose an Individual Plan when . . .	Choose a Group Plan when . . .
Performance measurement	Good measures of individual performance exist. Task accomplishment not dependent on performance of others.	Output is group collaborative effort. Individual contributions to output cannot be assessed.
Organizational adaptability	Individual performance standards are stable. Production methods and labor mix relatively constant.	Performance standards for individuals change to meet environmental pressures on relatively constant organizational objectives. Production methods and labor mix must adapt to meet changing pressures.
Organizational commitment	Commitment strongest to individual's profession or superior. Supervisor viewed as unbiased and performance standards readily apparent.	High commitment to organization built upon sound communication of organizational objectives and performance standards.
Union status	Nonunion; unions promote equal treatment. Competition between individuals inhibits "fraternal" spirit.	Union or nonunion; unions less opposed to plans that foster cohesiveness of bargaining unit and which distribute rewards evenly across group.

# Team Compensation: Issues and Problems

- Many varieties of teams – difficult to argue for one consistent type of compensation plan
- “Level problem”
- Complexity
- Control
- Communication

# Gain-Sharing Plans

- Employees earn bonuses tied to unit-wide performance as measured by a predetermined, gain sharing formula
- Looks at cost components of the income ledger and identifies savings over which employees have or impact



# Key Elements in Designing a Gain-Sharing Plan

- Strength of reinforcement
- Productivity standards
- Sharing the gains
- Scope of the formula
- Perceived fairness of the formula
- Ease of administration
- Production variability

# Types of Gain-Sharing Plans

- **Rucker Plan**
  - Ratio is calculated that expresses value of production required for each dollar of total wage bill
- **Scanlon Plan**
  - Designed to lower labor costs without lowering level of a firm's activity
  - Incentives are derived as a function of ratio between labor costs and sales value of production (SVOP)
  - SVOP includes sales revenue and value of goods in inventory
- Implementation of Scanlon/Rucker Plans
  - Two major components are vital to implementation and success
    - Productivity norm
    - Effective worker committees

# Types of Gain-Sharing Plans (cont.)

- **Improshare** (Improved productivity through sharing)
  - Standard is developed that identifies expected hours required to produce an acceptable level of output
  - Any savings arising from production of agreed-upon output in fewer than expected hours is shared by firm and workers

# Profit-Sharing Plans

- Predetermined index of profitability
  - Employees may not feel their jobs directly impact profits
- The trend in recent variable-pay design is to combine the best of gain-sharing and profit-sharing plans
  - The plan must be self funding
  - Along with having the financial incentive, employees feel they have a measure of control

# Earnings-at-Risk Plans

- Success sharing plan
  - Employee base pay is constant
    - Variable pay increases in successful years
    - No reduction in base pay and no variable pay in poorly-performing years
- Risk sharing plan
  - Employee base pay varies
    - Base pay often reduced in poor performance years
    - Shifts part of risk of doing business from company to employee

# Exhibit 10.16: Group Incentive Plans: Advantages and Disadvantages

## EXHIBIT 10.16

### Group Incentive Plans: Advantages and Disadvantages

#### Advantages

1. Positive impact on organization and individual performance of about 5 to 10 percent per year.
2. Easier to develop performance measures than it is for individual plans.
3. Signals that cooperation, both within and across groups, is a desired behavior.
4. Teamwork meets with enthusiastic support from most employees.
5. May increase participation of employees in decision-making process.

#### Disadvantages

1. Line-of-sight may be lessened, that is employees may find it more difficult to see how their individual performance affects their incentive payouts.
2. May lead to increased turnover among top individual performers who are discouraged because they must share with lesser contributors.
3. Increases compensation risk to employees because of lower income stability. May influence some applicants to apply for jobs in firms where base pay is a larger compensation component.

# Example of Group Incentive Plan - GE Information Systems

- A team-based incentive with links to individual payouts
- Team and individual performance goals are set
- If team hits its goals, team members earn their incentive only if they also hit their individual goals
- Team incentive is 12% to 15% of monthly base pay

# Example of Group Incentive Plan - Corning Glass

- A gain-sharing program (goal sharing) where 75% of payout is based on unit objectives such as:
  - Quality measures
  - Customer satisfaction measures
  - Production targets
- Remainder is based on Corning's return on equity (ROE)



# Example of Group Incentive Plan - 3-M

- Operates with an earnings-at-risk plan
- Base pay fixed at 80% of market
- Employees have a set of objectives to meet for pay to move to 100% of market
- Additionally, there is a modest profit sharing component

# Example of Group Incentive Plan - Saturn

- Earnings-at-risk plan where base pay is 93% of market
- Employees meet individual objectives to capture at-risk component
- All team members must meet objectives for any to get at-risk money
- A profit sharing component is based on corporate profits

# Group Incentive Plans: Examples

- All incentive plans can be described by common features
  - The size of the group that participates in the plan
  - The standard against which performance is compared
  - The payout schedule

# Explosive Interest in Long-term Incentive Plans

- Long-term incentives (LTIs) focus on performance beyond the one-year time line used as the cutoff for short-term incentive plans
- Recent explosive growth in long term plans is spurred in part by a desire to motivate longer-term value creation
- Evidence suggests that stock ownership is likely to increase internal growth, rather than more rapid external diversification

# Long-Term Incentive Plans

**Employee Stock Ownership Plans  
(ESOPs)**

**Performance Plans (Performance  
Share and Performance Unit)**

**Broad-Based Option Plans (BBOPs)**

# Exhibit 10.18: Long-Term Incentives and Their Risk/Reward Tradeoffs

## EXHIBIT 10.18 Long-Term Incentives and Their Risk/Reward Tradeoffs

Source: IOMA, "PFP News Brief," *Pay for Performance Report*, June 2000, p. 8.

### Level One: Low Risk/Reward

1. *Time-based restricted stock*: An award of shares that actually are received only after the completion of a predefined service period. Employees who terminate employment before the restriction lapses must return their shares to the company.
2. *Performance-accelerated restricted stock*: Restricted stock granted only after attainment of specified performance objectives.
3. *Stock purchase plan*: Opportunity to buy shares of company stock either at prices below market price or with favorable financing.

### Level Two: Medium Risk/Reward

4. *Time-vested stock option*: This is what most stock options are—the right to purchase stock at a specified price for a fixed time period.
5. *Performance-vested restricted stock*: This is a grant of stock to employees upon attainment of defined performance objective(s).
6. *Performance-accelerated stock option*: An option with a vesting schedule that can be shortened if specific performance criteria are met.

### Level Three: High Risk/Reward

7. *Permium-priced stock option*: A stock option that has an exercise price about market value at the time of grant. This creates an incentive for employees to create value for the company, see the stock price rise, and thus be eligible to purchase the stock.
8. *Indexed stock option*: An option whose exercise price depends on what peer companies' experiences are with stock prices. If industry stock prices are generally rising, it would be difficult to attribute any similar rise in specific improvements beyond general industry improvement.
9. *Performance-vested stock option*: One that vests only upon the attainment of a predetermined performance objective.

# Your turn

Answer the end of chapter 10 review questions